SMART INSURANCE REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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SMART INSURANCE REFORM

Thursday, June 16, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT-SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:02 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ryun, Bachus, Manzullo, Royce, Kelly, Ney, Fossella, Biggert, Barrett, Feeney, Hensarling, Davis of Kentucky, Kanjorski, Moore, Israel, Clay, McCarthy, Lynch, Miller of North Carolina, Scott, Watt, Davis of Alabama, Wasserman Schultz, and Pomeroy.

Chairman BAKER. I would like to call this meeting of the Capital Markets Subcommittee to order and welcome all our participants this morning.

The committee is again revisiting a subject which we have examined over the course of literally years on many occasions, the goal of which is to provide a regulatory system which enables creativity and innovation in insurance product while serving the interests of consumers in the most responsive manner possible.

The history of insurance regulation in the Nation is one of some considerable interest to anyone who has reasons to purchase or rely on deliverability of an insurance product, and the work of the committee specifically over the past several years has been to try to seek out a balance of all the competitive stakeholder interests and at the same time move toward a system which is more reflective of free market principles.

It is difficult to understand how a very simple, straightforward life insurance policy, which is intended to be sold nationally, will require 54 different regulatory entities' approval before it is permissible to market nationwide.

I will simply go back to comments of commissioners over the course of the last few years. In 1999, the then-president of the National Association of Insurance Commissioners, President Reider, stated that regulation and regulators will have to change if they expect to maintain relevance, admitting his own frustration in hearing people say not just in his own department but in commission meetings that they are not going to change because they have always done it in that way in the past. He was committed to change.

In the year 2000, NAIC President Nichols stated that if regulation of insurers market conduct does not change, then the States' right to regulator insurance could be lost.

In 2002, NAIC President Terri Vaughan stated, "There are many cases where it is difficult to rationalize the different regulatory requirements across States. Many of our regulatory differences are the result of historical accident rather than a reasoned response to differing market conditions."

In 2004, NAIC President Ernie Csiszar stated, "The system has outlasted its usefulness in many ways. Regulators tend to over-regulate the trivial, such as the reams of paperwork, and under-regulate the essentials, like solvency and corporate governance issues."

In an earlier committee hearing, two commissioners participated. Michigan's Insurance Commissioner Fitzgerald and then-Ohio Commissioner Covington responded to a question from Chairman Oxley, which was, "If Congress sets a goal of 3 or 4 years for achieving comprehensive uniformity by NAIC for product approval, do you and Mr. Fitzgerald feel confident you can meet the goal?"

Mr. Covington responded, "Chairman Oxley, I think we have got to meet that kind of goal. As we have said before, the current system is not good for consumers, not good for the companies. We must meet that goal."

Mr. Fitzgerald responded, "I agree with that, and if over the next 2 to 3 years you have not seen significant progress, I think there is a need to have questions raised about whether we can effectively, at the State level, solve problems that you have helped to identify and that we are identifying as well."

The disappointment is that was 4 years ago, and I think that is the platform from which I would like to begin today. This is not about assigning responsibility to any individual, to any organization. It is merely the point that the Congress has been, over a period of many years, been saying to those who are in the regulatory business, "Let's get this fixed." And we have had many different approaches to get it fixed. Unfortunately, at least in my perspective, it is still not fixed.

If the SMART Act is viewed as an inappropriate response to the identified problems, then I am still looking for someone to place on the table the response that is appropriate in light of all the identified concerns that most commissioners have agreed in fact do exist.

So as we go forward, we will again revisit the provisions of the SMART Act, attempt to come to some agreeable resolution on an approach which the committee finds advisable and hope to move forward in the coming months with a proposal that provides the relief that I think all of us agree is warranted and justified.

Mr. Moore, did you have an opening statement?

Mr. MOORE. Yes, I do. Thank you, Mr. Chairman.

Chairman Baker, I would like to thank you for holding this hearing today on ways that Congress can improve and strengthen the State-based system of insurance regulation.

And I also want to thank our witnesses who have flown in from around the country to testify here today and the ones at the table.

I look forward to hearing from our witnesses ways in which this committee and Congress can work together toward greater uni-

formity in insurance regulation with the goal of modernizing regulation of an industry that plays an important role in our economy and in the daily lives of our constituents.

I also look forward to hearing from our witnesses the ways in which NAIC is currently attempting to achieve uniformity at the State level. I appreciate the efforts of Chairman Oxley and Chairman Baker to modernize insurance regulation, and while I do not support the SMART Act as currently drafted, I think the debate over how Congress can and should reform the State-based system of insurance regulation is certainly worth having.

I hope that as this process moves forward, this committee will be able to forge a compromise that will result in uniform improved standards in the areas of market conduct, insurer and in producer licensing and multi-State filing of life insurance forms, among others, as well as more competitive markets for personal lines, which will ultimately benefit our consumers.

In the area of fostering greater competition in the insurance marketplace, Mr. Chairman, I have real concerns with Title 16 of the SMART Act, as currently drafted. The State of Kansas currently operates under a relatively competitive file and use system for most lines of insurance, and while greater competition and market-based pricing would apply downward pressure on rates, total rate deregulation could have a potentially detrimental effect on consumers.

As the SMART Act process moves forward, I will continue to explore the flex rating provisions in Title 16, which would allow for greater pricing freedom without wholly preempting the States' ability to review rate increases or decreases.

The National Conference on Insurance Legislators has an interesting flex rating model law that may be worth considering, and the States' experience with flex rating from Alaska to South Carolina and many in between could be instructive as well.

Again, Mr. Chairman, thank you for holding this hearing, and I look forward to hearing from our witnesses.

Chairman BAKER. I thank the gentleman for his statement.

Mr. Ryun?

Mr. RYUN. Mr. Chairman, thank you for convening this hearing.

And I want to thank all of our witnesses. I look forward to your testimony.

Our goal in this reform process is to improve uniformity between States but also to increase competition and improve consumer choice.

As we move toward this goal, I am hopeful that we are able to achieve it through existing State-based systems. I believe that our end goal must continue to make the State systems work without a Federal regulator.

Throughout this process, the committee has received input from all sides of the industry, including the State insurance commissioners, and I am pleased that we have a number of our commissioners, both past and present, here with us today, and I would particularly like to welcome our Kansas State insurance commissioner, Sandy Praeger, whose advice I appreciate and whose input I will continue to look forward to.

There are certainly differences of opinion on what form this effort should take, but there is wide consensus that improvements need to be made. I believe that we must continue to focus on improving uniformity between States. This will help avoid the race to the bottom with companies drawn to States with less stringent laws.

Mr. Chairman, I appreciate the attention you are giving this matter. I look forward to the hearing and our witnesses, and I yield back my time.

Chairman BAKER. I thank the gentleman for his statement.

Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman. I want to first thank you for holding another important hearing regarding the SMART Act.

And I also want to thank the distinguished panel members and witnesses today for their testimony on this important subject.

Efforts to streamline insurance regulation by the States have been slow in development, and I agree with those that say that interstate insurance products need to be treated as interstate commerce by our regulators. However, this is my point: I remain skeptical about the need for a new, large Federal bureaucracy to completely replace the current State regulatory structure we have.

Now, since Chairman Oxley and Chairman Baker have announced their road map for insurance regulatory modernization, I have been interested in understanding the differences between the different States' insurance rate regulations. I look forward to a discussion today about the States that have moved toward less regulation and the effects that that has on consumers.

Any legislation the committee considers must balance streamlined regulations for businesses with consumer protections. I will not support any legislation that does not provide strong consumer protection against discriminatory practices and that does not protect personal financial data and personal health data.

The States have strong regulations against discriminatory practices and anticompetitive practices, and many of these laws do not harm overall market competition.

Thank you again, Mr. Chairman, and I yield back the balance of my time.

Mr. ROYCE. [presiding] Thank you, Mr. Scott.

Let me begin by commending Chairman Baker but also commending Chairman Oxley for their efforts to modernize the regulation of our Nation's insurance industry. I think we can all agree that consumers of insurance products can benefit from more efficient regulation, and it is clear to me that the leadership of this committee is trying to help the marketplace for the better.

I support the intent of the SMART Act, which is to harmonize regulatory standards of over 50 regulatory regime insurance providers, the regime that frankly every one of these providers must face in 50 States, in 50 jurisdictions.

Let me add, though, that in addition to SMART, I believe that this committee should also consider creating an optional Federal charter for insurance companies. And in my view, this optional Federal charter would improve the insurance marketplace to the benefit of consumers.

If we take the life insurance marketplace as an example, life products do not share geographic characteristics that may be prevalent in other insurance sectors. If life insurers could go to one regulator for approval to offer their products, then insurance firms would spend less time in negotiations with 55 different regulatory bodies and more time developing market-friendly products.

Furthermore, fewer obstacles to entry would create a more competitive market, giving consumers more choices and certainly more choices at better prices if they did not have to go through this regulatory conundrum.

I have great confidence that an optional Federal charter would drive much needed market-based reform, and frankly the consumer would be the greatest beneficiary with lower costs if this were done.

The benefits of an optional Federal charter would not be limited to the consumer, however. As a member of the International Relations Committee, I have pressed other nations to open up their markets to our financial services products, such as India and Korea and countries across Africa.

Unfortunately, in many of these government-to-government negotiations, the insurance sector is not well represented because there is no Federal regulatory body with a seat at the table. Banks and thrifts have many voices to drive pro-growth policies—the Fed, the FDIC, the OTS, the OCC. However, the insurance industry does not have a strong voice speaking on its behalf.

The creation of an optional Federal charter would go a long way to solve this problem and will result in more jobs, higher wages for thousands of employees in the insurance industry and better returns for debt and equity investors.

I am a strong supporter of increasing efficiency in our insurance marketplace. Consumers will be the greatest beneficiaries, but our economy would also benefit.

Again, I appreciate the leadership of Chairman Oxley and Chairman Baker on the SMART Act, and I hope they will also entertain the idea to create an optional Federal charter for insurers.

And at this time, let's go to the next member in succession, that would be Mr. Miller. No statement?

Mr. Watt, do you have an opening statement?

Mr. WATT. Thank you, Mr. Chairman. I will not take 5 minutes or 3 minutes, whatever the time limit is.

I would just observe from my service, both on the Financial Services Committee and the Judiciary Committee, how striking it is that a group of people who came to power professing support for States' rights have just so completely and thoroughly disregarded the notion in so many ways that I just cannot allow it to go without mention.

I guess the reason I came to this hearing was to try to understand how this or anything else in this area, as I have been trying to understand in tort law, which throughout my lifetime had been reserved to the States, in insurance law, in predatory lending. I mean, the list just keeps growing and growing and growing of areas in which people who have come into government railing against the power of the Federal Government and talking so aggressively about how they support the rights of States just think

that States are stupid now and that they somehow have a monopoly on the ability to regulate everything and do it correctly.

I just do not understand it, and I mean, I keep trying in every context in which we are given the opportunity, and I still do not understand. Maybe some of these witnesses or the Chair or somebody will tell me how this fits, because I do not get it. I do not get it.

I yield back, Mr. Chairman.

Mr. ROYCE. I thank the gentleman for yielding back. I will just point out that the Articles of Confederation did not work that well for this Republic, so several hundred years ago we went to a system that was federalist in nature where the Federal Government handled—

Mr. WATT. Is this in response to my—

Mr. ROYCE. I am just continuing my remarks, taking the opportunity since the gentleman yielded back.

Mr. WATT. I thought you had already made your remarks.

Mr. ROYCE. Well, I am using up the remainder of my 5 minutes just explaining that in other areas of commerce this has worked out fairly well, but there was a reason why we gave up on the Articles of Confederation and why we found that interstate commerce was very efficient when handled at the Federal level.

And with that said, let me move to Mr. Ney of Ohio for his opening remarks.

Mr. NEY. Thank you, Mr. Chairman.

I want to thank Chairman Baker for holding the hearing today.

Personally, I will be in and out at some meetings, but I intend to come back and also look over the testimony, because I think it is important. Also, I think your testimony today will be interesting, as some of these are former commissioners, of course. Lee Covington is here, who was our commissioner in Ohio.

When I was in the State senate, I chaired the Insurance and Banking Committee. That is what we called it, Insurance and Banking. At that time, back in Ohio, it was said that if interstate banking came to the State of Ohio, it would completely finish the State off, and how dare there be a concept of interstate banking. A lot of things have changed, a lot of things have blended.

But I will give an observation at that time in the State senate, up to 1994 when I left there, whether it was Dick Celeste as Governor, with his insurance commissioner, or after that, Voinovich, or even before that, Jim Rhodes, when he was Governor, Democrat or Republican, the insurance commissioners would come to us and their staff and they would say, “This is what has happened.” The National Association of Insurance Commissioners and States would start to fall in line to conform to some Federal policies of adopted provisions. I thought that worked pretty good.

I am not sure, and this is not a dispersion on individuals or anything, I am just not sure that that has happened in the recent past.

Ann Benjamin, our insurance commissioner, comes and talks to us regularly. I think she does a great job, as I think Lee did in our State. I think we have had a good, well-run State. But as I told Ann, if there are internal disputes there where something is not working right today, that is not going to cut it here on Capitol Hill, and it will lead to questions about should we have this type of leg-

islation. I do not pretend to know this legislation backwards or forwards, but I give Chairman Baker and Chairman Oxley credit for introducing this to get the subject laid out on the table. Some people want an optional Federal charter.

The only thing I would warn, though, because I remember with the insurance agents and different groups, when they came to talk to you in the legislature, you had to raise your hand and say, "I swear to the McCarran and Ferguson principles," and then you could have a decent conversation. So things change.

But the one thing I would throw out there, and it has got to be thought well through, this is just not an easy piece of legislation or law to look at. If you have a Federal entity and this Federal entity is created and something does not go right and we create another Federal entity and hire more staff and they become the regulators, and then everybody runs to Capitol Hill saying, "We just had a Federal rule proposed and we hate that and let's go fight it," sometimes people will get what maybe they wish for. And I just think as the process goes, that we just have to consider the States' end of it but also consider how this would be pieced together, will it really work?

So I am up in the air on some things, but I think your testimony will be valuable today to take a good look at maybe what has went right and what has went wrong in putting this together nationally through the States.

Thank you, Mr. Chairman.

Mr. ROYCE. Thank you, Mr. Ney.

The ranking member, Mr. Kanjorski, of Pennsylvania.

Mr. KANJORSKI. Thank you, Mr. Chairman.

We return this morning to a topic that we have often discussed in recent years, the need for insurance regulatory reform. No matter what side one takes in this long-standing debate on regulatory efficiency, it has become clear to me that this is no longer a question of whether we should reform insurance regulation in the United States; instead, it has become a question of how we should reform insurance regulation.

As you know, Mr. Chairman, we have begun to develop a growing consensus in the Congress about a need to improve insurance regulation. In an attempt to advance these efforts, you have also crafted a lengthy and complex outline for achieving regulatory reform in the insurance industry. This evolving proposal has, at best, received lukewarm support from many of the parties to which I have spoken about the draft reform plan.

Many participants in the insurance community have also expressed strong reservations and deep concerns about this plan. For example, the North Dakota legislature has passed a resolution indicating that the proposal would "impair, erode and limit the ability of State governments to regulate the business of insurance."

A committee in the Ohio assembly has also urged us to oppose the plan. In addition, the National Association of Realtors has expressed its opposition to efforts to impose "a system of mandatory, uniform national standards for personal and commercial property insurance."

Moreover, the consumer groups have determined that the sweeping proposal would override important State consumer protection

laws, sanction anticompetitive practices by insurance companies and incite State regulators to further weaken insurance oversight.

After expending considerable time and effort studying these matters, Mr. Chairman, the National Association of Insurance Commissioners have raised their own concerns about your proposal to reform insurance regulation. I am therefore very pleased that we will have before us today the leader of this venerable organization. Diane Koken is a savvy and confident overseer of Pennsylvania's insurance markets. Because she has also served under Republican and Democratic governors, she can offer us a bipartisan perspective on insurance regulatory reform.

During our previous hearings on insurance reform, we have received extensive testimony from many witnesses advocating the creation of an optional Federal charter.

Mr. Chairman, although your evolving plan still does not address this important issue, the consensus for creating such a charter continues to grow. Rather than overlaying the Federal bureaucracy on top of State regulation, an optional Federal charter would, in my view, create a sensible, separate and streamlined regulatory system. Such a dual oversight has worked generally well in the banking industry for many decades, and we should now consider applying it to the insurance industry as well.

Moreover, because of its standardized products and nationwide marketplace, the life insurance industry, from my perspective, is particularly ready for the adoption of an optional Federal charter.

While the issue of insurance regulatory reform is an important one, I am very disappointed that we are meeting on a bill that has yet to be introduced, for which there is no pressing need before resolving the critical issue of extending the Terrorist Risk Insurance Act.

After tomorrow, we will have just 9 weeks remaining on the official legislative calendar for this session. The Federal backstop to provide economic stability for American workers and businesses, however, will expire at the end of this year. We need, therefore, to move expeditiously on matters of the greatest importance.

We need to improve the Financial Services Committee legislation to extend this important program. We need to write a report. We then need to pass the bill on the House floor. We also may need to work to resolve any differences with the Senate's version of the legislation to extend the program. The time is short, we need to act now to extend the Terrorism Risk Insurance Act.

In closing, Mr. Chairman, I commend you for continuing to focus our committee on issues of insurance regulation. I also hope, however, that we will henceforth get our priorities in order and resolve the issue of extending the Terrorism Risk Insurance Act as quickly as possible. These are important discussions for us to have and important matters for us to resolve.

Thank you.

[The prepared statement of Mr. Kanjorski can be found on page 60 of the appendix.]

Mr. ROYCE. Thank you, Mr. Kanjorski.

We will go to Mr. Hensarling from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman.

And I certainly want to thank Chairman Baker for his hard work on this issue that is very important to American consumers.

I believe the best and most effective consumer protection is always going to be a competitive marketplace. That is where I believe we should concentrate our legislative efforts. That is why I am very glad to see that the SMART Act draft takes a number of serious steps to make our insurance markets more competitive and thus more consumer friendly.

History, hundreds of years of history and including recent history shows us that competition works. In the not-too-distant past in our Nation's history, the airline trucking industry, long distance industry, natural gas industry, to name a few, were all heavily regulated. Many had barriers to entry, all had some facet of price controls. And yet we finally came to a more enlightened view, and as a Nation, as we deregulated these industries, real prices fell 15 to 40 percent in a 2- to 5-year period.

And so I think we need to look at history as our guide. It shows us that in order to get to a point of effective competition in the insurance industry, we have got to carefully examine what has been limiting choice and driving up costs for consumers. I believe one of the most important factors is, quite simply, price controls.

And, certainly, I believe the evidence continues to mount that consumers living in States with minimal or no price controls pay significantly less for most types of insurance than do consumers residing in States with significant price controls. These consumers have experienced firsthand the benefits of a deregulated insurance system, so it is important that we look to these States as models when considering any type of regulatory reform.

I am particularly looking forward to the testimony of Mr. Shapo—did I pronounce your name right? Shapo. I am particularly looking forward to Mr. Shapo's testimony in regard to the Illinois experience, which I think will be quite instructive.

And, so, again, Mr. Chairman, I look forward to working with all my colleagues in doing something that can make insurance more affordable for the vast majority of Americans.

And with that, I yield back my time.

Mr. ROYCE. Thank you.

Mrs. McCarthy of New York, do you have an opening statement?

Mrs. MCCARTHY. Thank you, Mr. Chairman. No, I will wait for listening to the witnesses and then ask my questions. Thank you.

Mr. ROYCE. Thank you. We will go to Ms. Sue Kelly of New York.

Mrs. KELLY. Thank you, Mr. Chairman.

The McCarran-Ferguson Act enshrined the principle of State regulation of our national insurance market. State regulation of insurance insured that customers received the best protection and that developers of insurance products were meeting the needs of all consumers in the market.

In the 60 years since the McCarran-Ferguson Act was passed, financial markets have changed immensely, and competition within the insurance industry and between insurers, banks, and securities firms has become really fierce.

While national and international standards exist, the emerging insurance retains the same regulatory patterns, unfortunately.

Several years ago, this committee took the lead in passing NARAB to encourage States to adopt a uniform licensing standard or face a National Association of Retail Agents and Brokers. And we wrote that bill so that we would encourage the industry to police itself. The measure has worked to bring the States together but has not eliminated duplicate regulation, and it is not finished.

I support States' rights, and I oppose Federal preemption of States. Consumers, however, are the ones who are harmed by the inability of the insurance industry to compete nationwide on financial products. The sick and the elderly need access to new products that recognize changes in medicine and retirement savings. Homeowners and small businesses need new products to match their growth in equity and opportunity.

I urge the current and former commissioners who are present here to work with each other, to work with the industry and to work with this committee to develop an insurance market for the 21st century. We are not there yet.

I also want to note that TRIA, the Terrorism Risk Insurance Act, expires at the end of this year. Millions of policyholders around the country are already being notified that their terrorism insurance will not be available for them next year if this Congress does not act. Our economy cannot afford to be slowed down by the fear of loss from terrorism. We must have terrorism insurance, and it must be available, and it must be available soon.

I am pleased to see that New York's former insurance commissioner, Greg Serio is here. He has been a tireless advocate for TRIA and for insurance consumers in New York nationwide. I look forward to hearing from him, and I look forward to hearing from all of the witnesses here today.

Thank you.

Mr. ROYCE. Thank you, Ms. Kelly.

Now we will go to our testimony from our panel of witnesses. We thank them for joining us today.

We are going to hear first from Mike Pickens, testifying as the former State insurance commissioner, Arkansas Department of Insurance; and then Greg Serio, testifying as the former superintendent of insurance, New York State Insurance Department; Lee Covington, testifying as the former director of the Ohio Department of Insurance; Nat Shapo, testifying as the former director of the Illinois Department of Insurance; Diana Koken, Pennsylvania Insurance commissioner, testifying as president of the National Association of Insurance Commissioners; and Ed Muhl, testifying as the former insurance commissioner of Maryland and the former superintendent of insurance for New York State Insurance Department.

We will start with Mike Pickens.

STATEMENT OF J. MICHAEL PICKENS, TESTIFYING AS THE FORMER STATE INSURANCE COMMISSIONER, ARKANSAS DEPARTMENT OF INSURANCE

Mr. PICKENS. Mr. Chairman, ranking member and committee members, thank you once again for this opportunity to testify on the important issue of insurance regulatory reform.

I want to take this opportunity to commend the chairman and all the committee members on your continued interest in and enlightened progressive work on this important issue. This is an issue that is vital to all of us who are insurance consumers, to our financial services marketplace, and to the United States economy.

It is consumers, not the insurance industry, who bear the burdens and pay the costs when regulation is ineffective and when regulation is inefficient. This issue of regulatory modernization is not about deregulation, it is about better consumer protection, it is about more competition, and it is about better products and better prices for consumers.

When I was NAIC president in 2003, our membership, which included at that time some 22 brand new chief regulators, made it clear they wanted the NAIC to have a strong, credible voice in Washington, D.C. That is why we created a Governmental Affairs Committee, we created the State-based ASSURE initiative, and we hired Washington insiders to help us educate Congress about our issues.

At that time, as now, State regulators were faced with essentially three options. Number one, we could develop our own modernization plan and get it passed in each State, one State at a time. We could engage the House Financial Services Committee and the subcommittee and provide technical expertise and input on the Federal tools of the SMART approach where the threat of preemption could be used as both a carrot and a stick to help expedite necessary and appropriate State-based reforms. Or we could do nothing and confront the very real possibility of the creation of a so-called optional Federal charter, which would result in total preemption and the total loss of all State authority.

Wisely, in 2003, our membership chose options one and two. We met in Austin, Texas, and we pounded out our plan, which we entitled, "A Reinforced Commitment Insurance Regulatory Modernization Action Plan." We also began to work hard implementing this plan in each and every State in the country. And, in addition, we began working to develop a relationship based on credibility, trust and technical expertise with Members of Congress.

It is in this spirit of consumer protection, reform, credibility and trust that I began working with this committee when I became an NAIC officer. It is also in this spirit that I and others were asked earlier this year to work with committee staff in providing objective, expert input on the SMART initiative.

Now, let's give credit where credit is due. State regulators, working through the NAIC, have in fact made some progressive progress in implementing the 2003 action plan and their 2004 road map. They have worked hard, and they have made significant progress in bringing about uniformity of laws and administrative and regulatory processes in the areas of producer and company licensing, making better products available to consumers just as quickly as possible and working to protect consumers from fraud in areas like viatical sales and sales of insurance policies on military bases. And where appropriate, State regulators have provided their expertise to Congress on Sarbanes-Oxley, the Terrorism Risk Insurance Act, the U.S.A. Patriot Act, asbestos, civil justice and med-

ical malpractice reform and international insurance issues, among a host of others.

Still, as hard as they are working, State regulators are somewhat limited in how much they themselves can do to pass needed laws and implement what I think we all agree are long overdue reforms. State regulators must have the help and support of their governors and their legislators to implement the reforms.

However, in far too many States, and all of us have seen this, when budget gets tight, State regulators see their consumer trust funds raided for other purposes, their programs are frozen or they are cut, their legislation gets caught up in the politics of the moment, whatever that may be, and some of their most experienced personnel leave State government for the perceived greener pastures of the private sector. Reforms get stalled, they languish, and are eventually pushed aside.

This is not in the best interest of our consumers or of our insurance markets. Regardless of how hard they work, State regulators cannot do the job alone, and they need your help and support.

Now, I am a strong supporter of State insurance regulation, and that is why I have been willing, and I appreciate the committee asking me to engage and work with the committee on the SMART approach. I want to make it very clear today that I am opposed to Federal preemption of State insurance laws, but it must be noted, under the SMART approach, preemption need never occur.

SMART does not use preemption but rather it uses the threat of preemption to help State regulators overcome the political and other obstacles that exist in some States so that they can in fact implement, enforce, and continue to regulate the reforms that they already have promised under our 2003 action plan and the 2004 road map. Honestly, I see SMART as an opportunity for State regulation, not as a threat.

Gramm-Leach-Bliley required States to develop and implement producer licensing reforms, and as Representative Kelly mentioned, if this was not done within a specified period of time, State regulators would lose their authority to a newly created Orwellian-sounding Federal agency—the National Association of Registered Agents and Brokers. How did the States respond to this threat of preemption? They set an NAIC speed record in creating a model law and getting it passed and implemented in all the States, including the largest markets in the country.

Similarly, following a rash of high-profile insolvencies in the late 1980's and 1990's, Representative Dingell of Michigan encouraged, and I use that word kindly, encouraged State regulators to reform or to be eaten alive by the Federal Government. State regulators responded affirmatively and developed the NAIC Financial Solvency Accreditation Program. So this approach that is used under SMART has been used in the past, and State regulators have responded positively.

You know, it is said that the greatest champions respond to the greatest challenges. They rise to the occasion, they work best and they deliver the most when the stakes are the highest. In my book, State insurance regulators are in fact great champions who will, as they have always done, respond courageously and prove to be victorious when the chips are down.

But from my objective perspective, they need your support and your help, and SMART just may—just may—be the tool State regulators need to help expedite promised reforms in the State.

Thank you for this opportunity to work with you on this initiative, and I look forward to answering your questions.

[The prepared statement of Mr. Pickens can be found on page 127 of the appendix.]

Chairman BAKER. Thank you very much, sir. I appreciate your good statement.

Next witness is Mr. Gregory V. Serio, former superintendent, New York State Insurance Department.

STATEMENT OF GREGORY V. SERIO, TESTIFYING AS THE FORMER SUPERINTENDENT OF INSURANCE, NEW YORK STATE INSURANCE DEPARTMENT

Mr. SERIO. Good morning, Mr. Chairman and members of the subcommittee.

Modernizing insurance regulation is a multifaceted undertaking, comprising the dual tasks of updating both insurance statutory standards as well as insurance regulatory standards, in addition to monitoring case law developments that also serves a role in the evolutionary process of the law.

Insurance regulators and legislators both saw the need for modernization as a matter of culture rather than as a static event, and their representative groups—the NAIC, the National Conference of State Legislatures and the National Conference of Insurance Legislators—undertook a series of initiatives over the past 5 years to help construct a coordinated approach to insurance reform.

Key to that effort was the creation of a productive dialogue with key members and committees in Congress, this subcommittee and you, Mr. Chairman, and your members, chief among them, to forge a consensus on the key areas needing reform and the best way to achieve these mutually desirable goals.

The underlying common thread among all the players, both Federal and State, in the early stages of the insurance reform dialogue was to avoid replication of the awkward dynamics of the discussions leading up to the passage of the Gramm-Leach-Bliley legislation where it is universally agreed that State insurance, legislative and regulatory community members, did not have an effective voice in that process.

Having a seat at the table, as they say, and, more importantly, a voice that would and could be heard, was a critical condition precedent to engaging in any discussion on insurance modernization.

Equally well understood, however, was that seats at the table had to be earned by a willingness to compromise for the larger good of meaningful insurance reform. Quality of the insurance reform being considered in these early discussions was measured by the same standard that is still being applied to the current deliberation: Can adequate uniformity in laws and regulations be achieved so as to be able to justify the continued support of the State-based system of regulation?

Uniformity was, and continues to be, the gold standard for measuring effective modernization of State insurance regulation, but it

also has proven to be a far more elusive goal than many had thought. Perhaps it is because some did not realize that the quest for uniformity within a State-based system would still require some States to shed some individual autonomy. Perhaps it is because some erroneously thought that uniformity would mean deregulation when it clearly does not. Or perhaps it is because at the end of the day there may not be the same level of commitment to modernization of insurance policy and practice, as many had originally thought.

The ongoing dialogue between public policymakers and regulators must continue to focus on the issue of uniformity if we are to assure that laws keep pace with the rapidly changing dynamics of the domestic and international insurance market.

Uniformity is also a crucial element to the public's better understanding of insurance, how it works and what they can expect and should expect from it. In the mobile society we live in today, the public should have reasonable expectations that the rules applied in one jurisdiction are reasonably similar to those in another jurisdiction and that they are not forsaking adequate insurance regulatory protection simply because they are moving from point A to point B.

Uniformity also allows regulators to more smoothly and effectively join in joint regulatory actions with less concern for nuances from one State to another that could undermine or complicate a multistate market conduct or financial examination.

Indeed, uniformity would seemingly be the regulators' friend, allowing them to focus on examination, enforcement and consumer protection activities and the enemy of the unscrupulous market player who arbitrages the vast variety and the bodies of law and regulatory environments by opportunizing inconsistency in those State laws for mischievous purposes.

It would be unfortunate if the efforts to have regulatory modernization were hampered or stalled because of the inability to achieve consensus on uniformity of standards in certain critical areas. Inability to gain agreement on uniformity would also undermine all that which has occurred up to this point in time in the name of uniformity.

The NAIC's accreditation program, the many model laws and regulations promulgated by the NAIC and NCOIL, the successful implementation of the Gramm-Leach-Bliley functional regulation of financial holding companies by both Federal and State authorities and now the SMART legislative model put forward by the House Financial Services Committee are all examples of efforts taken individually and jointly by these entities to pursue greater uniformity in the statutory basis of State insurance regulation.

Most notably, the insurance industry compact, now passed by more than 15 States, a concept embraced by the NAIC and executed by the NAIC, first championed by NCOIL so many years ago and included within the SMART draft, provides a structural framework for assuring uniformity across the spectrum of issues over the long term.

To promote the concept of uniformity as the keystone to insurance regulatory modernization, the NAIC issued last year its road map for regulatory improvements to serve as a complementary doc-

ument to Chairman Oxley's vision for improvement of the State-based system of insurance regulation, as he laid it out to the NAIC at its spring 2004 national meeting.

Identifying points of consensus and earmarking points of disagreement allowed all participating in the working dialogue to find areas of agreement quickly on the so-called low-hanging fruit and to concentrate our efforts on the more specific questions before us. Indeed, the NAIC in its vision statement expanded the perspective of the chairman's view, at his invitation, I should say, by including provisions of greater financial surveillance and holding company oversight, two issues that have taken on even greater importance given the events of the past several months.

The two road maps were and are not competing documents. They were and are the basis upon which consensus on national standards can be built. The SMART bill, as currently drafted, is a worthy progeny of the original road map initiative. It contains many provisions that were originally in the NAIC vision statement. The SMART dialogue does not presume that the SMART draft will be the final word on any issue, as serious discussion still needs to be had on issues like rate regulation, the national partnership, and preemption powers. And State insurance regulators need to know that they are gaining the tools they need to effectively regulate the business of insurance in a new world order.

From the mutually constructive beginnings of these discussions and the valuable work products that have come from the open dialogue that has been the hallmark of this public policy undertaking, though there has been some erosion in the trust and confidence of all players with respect to that joint commitment to see this process through to what was once the articulated goal of all involved, to modernize State insurance regulation in a manner that benefits both insurance consumers and industry participants.

Consequently, those who would prefer a more radical reform of insurance regulation or those who envision a weakening of insurance regulation in the name of reform now see new life being breathed into their efforts largely on the strength of the notion that those who prefer to improve State-based regulation are now a camp divided.

Uniformity of laws and regulation will allow the State-based system of regulation to become more effective and efficient in its enforcement of the law, as already noted. It will also allow the industry's own efforts to improve regulatory compliance, internal controls and corporate governance to be more effective.

The self-regulatory mechanism model now in place in the securities market and embodied in the NAIC can be greatly replicated and enhanced in the insurance sector with greater uniformity of laws and transparency of regulatory processes.

Organizations like the Insurance Marketplace Standards Association, once challenged by the regulators to provide greater disclosure of information and transparency in their processes, has shown that self-regulatory bodies can thrive in insurance and even achieve greater regulatory efficiencies for its companies, as we have seen in New York, Texas, Massachusetts and now incorporated into the NAIC Market Examiners Handbook, accepting IMSA work

product and analyses in the planning and execution of market conduct exams.

Greater uniformity in laws and regulation can and will make self-regulatory and best practices organizations like IMSA even more effective at promoting good market conduct by insurers and better at integrating their activities into the standard regulatory process.

Uniformity, where applied, has paid dividends. In producer licensing, the flow of information between the States has given the United States for the first time a real national system of agent licensing regulation. At the same time, it has also made it infinitely easier for agents to expand beyond the borders of their space, creating a far more dynamic insurance marketplace.

The leveraging of technology by State insurance departments in this new regulatory paradigm has made life for agents and regulators even better. In product development, as seen in the concentration of efforts on life products in the Interstate Compact Initiative, and in the speed to market advancements made in New York, Ohio and elsewhere, real benefits in uniformity of process and policy are being realized.

Uniformity of laws, regulation and processes has been the stated goal of the NAIC since its origin over 130 years ago. It has been true to the quest and has made particularly impressive strides over the past 5 years from its statement of intent to its reinforced commitment to modernization, to the road map, to the passage of interstate compact legislation and producer licensing initiatives and other uniform standards.

Its members also know that modernization of regulation and the uniformity upon which it is based is very much a process and not an event. Changes will be necessary from time to time, and the ebb and flow of negotiation and compromise will always benefit all parties in the long run even if it seems that one side is giving more than the other at any given moment.

Maintaining the long-term perspective of preserving the State-based system of insurance regulation, not simply because it is the historical method of regulation but because it is the system best suited to meet the demands of a changing world, will be all the motivation that regulators to understand and embrace the give and take of the SMART deliberative process.

The Congress will also understand that it stands within the best position when it works with the States in a cooperative venture to improve the State-based system rather than substituting a new Federal regulatory body for a regulatory system that already works quite well and is poised to be even better with greater uniformity of policy and process.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Serio can be found on page 134 of the appendix.]

Chairman BAKER. Thank you very much, sir.

Our next witness is Mr. Lee Covington, testifying as a former director, Ohio Department of Insurance.

Welcome.

STATEMENT OF LEE COVINGTON, TESTIFYING AS THE FORMER DIRECTOR, OHIO DEPARTMENT OF INSURANCE

Mr. COVINGTON. Thank you, Mr. Chairman.

Mr. Chairman, Chairman Oxley, ranking member, members of the committee, I thank you for the invitation to testify before your committee today on the important issue of insurance regulatory reform.

First, Mr. Chairman, I want to express my deep appreciation for your past courtesies to me during my service as Ohio insurance director and the outstanding support and working relationship I had with you and your tremendous staff on a number of very important pieces of legislation. It is very good to be with you again today.

I have had the pleasure of working with the committee during the development of SMART, providing high-level policy and structural insights and technical assistance on specific issues addressed in SMART. I appreciate the opportunity to work with you to ensure consumers have the necessary regulatory protections, consumer choice, and competitive markets inuring to their benefit as well as assuring a reasonable regulatory environment for companies and agents delivering vital insurance products and services to policyholders.

During the past 5 years, since adoption of the NAIC's statement of intent, the NAIC, NCOIL, NCSL have all had great leadership, including one of the very best, my good friend, Commissioner Diane Koken, current NAIC president. Each organization has had an unprecedented level of commitment, focus, work, and energy throughout this time period, and their current and past efforts are really remarkable.

Significant progress has been made on a number of initiatives contained in the original statement of intent, as outlined in my written testimony, including operationalizing the national insurance producer registry and enhancing and deploying SERF under the strong leadership of Alabama Commissioner Walter Bell, who is with us today.

For very understandable reasons, other initiatives have been slower in development and implementation, and the effectiveness of some initiatives, as currently operationalized, remains unclear. For example, the NAIC–NCOIL market conduct surveillance model law was approved 4 years after the adoption of the statement of intent in 2000, and to my knowledge, only one State has adopted any version of that model to date.

And the property and casualty commercial rates and foreign policy model law, adopted in 2002, which incorporates a competitive rating system for most commercial lines insurance, based on actuarially sound principles, has not been adopted, and to my knowledge, has not been introduced in any State in the country.

After all the efforts to institute regulatory reforms over the past 5 years, regulators, legislators and other stakeholders widely recognize the challenges and obstacles to achieving reform, which includes most significantly the collective action issue.

The development of model laws and initiatives through the NAIC's extensive committee and consensus process takes substantial time, something all of your members have experienced here in Congress, I am sure, and in the end, the NAIC has no authority

to pass model laws, and the challenge of seeking adoption by individual State legislators is substantial, even with the strong support and work of NCOIL and NCSL.

And, also, another challenge is the continued proliferation of unwritten rules, known by most as "desk drawer" rules, and the lack of execution, according to the intent of a particular model law or reform initiative.

Based on the Ohio experience, necessary reforms can be implemented. Ohio was one of the first, or the first State, to adopt its own reform initiatives or the NAIC's reform initiatives, including SERF in 2000, with 40 percent of all filings now submitted via SERF, and the average review time of 15 to 20 days, a reciprocal agent licensing system enabling agents to be licensed within 5 days in Ohio and in all NIPR States, the use of market analysis data calls to focus resources on companies having the greatest likelihood of regulatory noncompliance and the implementation of a risk-focused approach to financial examinations, long used by the Federal banking regulators.

While no new measures were implemented with respect to rate filings, Ohio has long embraced a competitive rating system based on sound actuarial principles. And as a result, Ohio citizens consistently enjoy homeowner rates ranking from 2nd to 5th best in the country and automobile rates ranking between 14th and 17th best in the country.

With regard to the current national rate and form review process, which I understand Mr. Shapo is going to address in more detail, a little background may be helpful.

In December 2000, the NAIC issued its Speed-to-Market Working Group report, and in that report it recommended a no-filing system or informational-only filing for most commercialized rates and forms, and in spring 2002, based on the report, adopted the property and casualty commercial rate and policy form model law. While a very limited number of States have enacted independent incremental reform, no State, to my knowledge, has enacted the NAIC model.

With respect to personal lines rates and forms, with a very limited number of exceptions, the status quo remains in tact, and little interest appears to exist among regulators to even address the issue of personal lines rates.

In Ohio, for homeowners insurance, consumers enjoy an average savings of $160 to $170 compared to the yearly average for the rest of the Nation of $535. For automobile insurance, that savings again is around $170 off of the average of $775. And when compared to States with price control rate regulatory schemes, those savings would be even more. Competition works, Mr. Chairman, and I am pleased that you and your committee continue to pursue a competitive marketplace that benefits consumers.

Most, if not all, insurance regulatory stakeholders agree reform is needed, and the debate is about how, by whom and under what timeframe reform should be accomplished. Commissioner Koken, in her usual eloquent and thoughtful opening address during the NAIC summer meeting, reinforced this point.

To this end, fair questions for this committee to consider include: first, whether the States will ever be able overcome the collective

action issue; second, how long will it take States to complete this work; and, third, even if the necessary model laws are actually adopted, will States ever be able to operationally coordinate their work, as intended, when executing their duties under those laws?

SMART provides the opportunity for States to maintain a State-based regulatory system with needed reform. While some may object to the preemption provisions, which should only be used as a last resort, the question exists as to what other options do policymakers have if the States cannot institute the agreed upon reform initiatives?

Mr. Chairman and members of the committee, thank you again for the very positive working relationship in the past. I look forward to continuing to work with you and my friends and former colleagues at the NAIC to assure SMART meets our common goals of necessary consumer protection, consumer choice and competitive markets that benefit consumers.

I look forward to answering your questions.

[The prepared statement of Mr. Covington can be found on page 62 of the appendix.]

Chairman BAKER. Thank you very much, sir.

Our next witness is Nathaniel S. Shapo, former director, Illinois Department of Insurance.

Welcome, sir.

STATEMENT OF NATHANIEL S. SHAPO, TESTIFYING AS THE FORMER DIRECTOR, ILLINOIS DEPARTMENT OF INSURANCE

Mr. SHAPO. Good morning, Mr. Chairman. Thank you for the opportunity to appear before you again as you consider important issues pertaining to interstate commerce.

Mr. Chairman, if I generically describe the insurance market, hundreds of sellers intensely competing with each other for customers who actively comparison shop, no one would say that the industry should be subject to price controls, but insurance has a long history of government rate regulation. I will review this background briefly to explain why I believe these price controls in today's marketplace should be presumed unjustified.

Government regulation of insurance rates is entirely appropriate at its conception. In the 1800's and early 1900's, the fire insurance marketplace developed a unique market defect. Carriers routinely underpriced their products in the quest for market share. Crude reserving methods and unsophisticated financial oversight led to mass insolvencies following catastrophic urban fires, leaving consumers exposed in their hour of greatest need.

So beginning in the early 20th century, legislatures passed statutes which allowed and encouraged carriers to collude through rating bureaus. These statutes empowered insurance regulators to review rate levels for adequacy and excessiveness. These price controls were necessary to substitute for the usual regulator of price—competition—which had been intentionally destroyed.

Price controls were thus used to keep rates up to promote solvency, not down to ensure affordability.

In 1944, the Supreme Court declared that insurance was interstate commerce and that Federal law, including the Sherman Act, applied. The next year, convinced by industry and State regulators

that competition was harmful to solvency, Congress passed the McCarran-Ferguson Act, limiting the Sherman's Act applicability to insurance.

The Act intentionally incentivized all the States to allow collusion and to pass rate regulatory laws. This was a reasonable choice given conditions in 1945, but the auto and homeowners markets have changed since then. Independent carriers began competing with the fixed bureau rates that resulted from McCarran-Ferguson. Rate advances and carrier actuarial techniques and government financial regulation obliterated the need to artificially prop up prices for solvency purposes.

The market was transformed by competition, which is obvious to the most casual observer. For instance, many car insurers broadcast ads on national TV, each claiming to offer a better price, directly naming competitors and giving examples of better rates offered to specific consumers.

Even though rate collusion between carriers is over, price controls still thrive. They have morphed, however, from their original legitimate purpose as a solvency tool and are now used as a means to ensure product affordability.

Summarizing this history, since collusion was officially sanctioned by congressional and other policymakers, price controls were once entirely appropriate, but government rate regulation for the purpose of keeping a product affordable, as practiced today, is a cardinal sin in a competitive marketplace.

The mismatching of means and ends in insurance rate regulation is not benign. This committee has gathered extensive evidence demonstrating that rate regulation has not kept prices down; rather, it routinely distorts markets and withers supply to the detriment of consumers.

For instance, as this committee has heard, the New Jersey marketplace was ruined by rate rollbacks and aggressive prior approval regulation. Carriers left the State in droves, prices did not go down, and qualified applicants could literally not find coverage.

I was privileged to serve as Illinois director of insurance for 4 years. Illinois has no law prohibiting excessive or inadequate rates in personal, auto and homeowners insurances, but rates are surely regulated in Illinois. Instead of government passing on the proper price a seller can pay in a competitive market, personal lines, auto and homeowner rates are regulated by the most ruthless force in a capitalist economy: The law of supply and demand.

Illinois has consistently had the most or nearly the most carriers writing auto and homeowners insurance of any State in the country. Prices have been stable, either in the middle of the State rankings or below average. Coverage in Illinois is not just affordable, it is widely available. The assigned risk plans have far less than 1 percent of the market.

Illinois regulates the insurance marketplace in areas where consumers are in need of government intervention. Consumers cannot fully understand solvency forms and market conduct where the State affirmatively regulates these aspects of the market to prevent a race to the bottom. This includes monitoring the market for unfair discriminatory practices.

Government must do this to protect consumers. The consumers do know how to protect themselves by comparison shopping based on price. They do it every day in every other competitive market. Competition keeps prices reasonable, it reacts to the marketplace far more nimbly than government can ever hope to, and it ensures a capital without fear of irrational government capture flows to market, producing adequate supply. Nothing about insurance makes it immune from these laws of economics.

Because of this, I note that market-based reforms in other businesses were referenced by the committee this morning. None of these markets, as described, were nearly as competitive as insurance. Why is the more competitive industry still subject to price control? Thus, the Illinois system should not be considered an experiment, nor should it be regarded as unusual. Illinois' approach could not be more mainstream.

Instead, government price controls in a competitive market are strained. This is very much Congress' concern. Insurance price controls greatly affect interstate commerce in many ways, since government capture of insurers' capital in one State affects policyholders in other States by putting the common fund at risk. I believe that Representative Kelly and I spoke about this issue the last time I testified here.

Rate regulation does not serve the purpose for which it is used today, and it diverts scarce government resources from areas where consumers cannot protect themselves and where government must regulate. And, quite unfortunately, price controls needlessly antagonize property casualty carriers. These companies should be natural allies of State regulation, because their products are attune to local markets which are affected by backers particular to individual States, like tort law.

But more and more such carriers, including former staunch supporters of State regulation, are openly supporting a Federal charter in Congress. This is particularly disconcerting to someone like me whose strong preference has always been to retain the primacy of State regulation if feasible, because I believe that State regulators are professional and dedicated public servants who ably perform an essential social function.

Thus I urge the committee that if it pursues insurance reform legislation, rate regulation should be at the top of the list, bar none. Nothing could be more appropriate than for the congressional committee tasked with regulating a particular kind of interstate commerce to examine that market, which this committee has done, create a full record which demonstrates that the conditions which spurred a previous and unique congressional policy choice are no longer present, which this committee has done, and to update the law to bring an outlier industry into line with prevailing American public policy, favoring a regulation of competitive markets by supply and demand, which this committee is considering.

I would like to conclude by sincerely thanking Chairman Baker for his outspoken support of competitive markets. The chairman should be commended for his clear thinking and political courage in making this a priority.

Thank you again for your time and consideration.

[The prepared statement of Mr. Shapo can be found on page 140 of the appendix.]

Chairman BAKER. Thank you very much, sir. I appreciate your courtesy.

Our next witness is Ms. Diane Koken, the Pennsylvania insurance commissioner, also appearing here today as president of the National Association of Insurance Commissioners.

Welcome, Ms. Koken.

STATEMENT OF M. DIANE KOKEN, PENNSYLVANIA INSURANCE COMMISSIONER, TESTIFYING AS PRESIDENT, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Ms. KOKEN. Mr. Chairman and members, thank you very much for the opportunity to be here with you today.

And I am pleased to also mention my fellow regulators that are joining me here today. Sitting behind me is the president-elect of the NAIC and the superintendent of Maine, Alessandro Iuppa, and secretary treasurer of the NAIC and elected commissioner from Kansas, Sandy Praeger, and also the commissioner from Alabama, Walter Bell, and the director from Idaho, Gary Smith.

I was first appointed as insurance commissioner of Pennsylvania in 1997. I have since served under three different governors, starting with Tom Ridge, Governor Schweiker and currently Governor Rendell.

Prior to my 8 years in public service, I was the general counsel of an insurance company and had been there for 23 years. So I have over 30 years of commitment to insurance, because I believe it is important to American families and to American businesses.

It is important for insurance regulation also to be responsive to the needs of a modern and evolving regulatory marketplace. State insurance regulators recognize the importance of safeguarding insurance consumers. We believe that the State regulators perform well as functional regulators and that State officials are in the best position to respond quickly and to fashion remedies responsive to local conditions.

State insurance regulators are public servants elected and appointed, representing the same people who are your congressional constituents. We share your goals regarding the importance of regulation that balances the need for vigorous consumer protection with vigorous business competition to provide a healthy insurance marketplace for consumers. We are proud that responsive and effective consumer protection is the hallmark of State insurance regulation.

The States and the NAIC are on time and on target to modernize State regulation where improvements are needed while preserving the benefits of consumer protection that is our real strength. In some areas, the goal is to achieve national uniformity because it makes sense for both consumers and insurers. In areas where different standards among States reflect regional needs, we are harmonizing State regulatory procedures to ease compliance by insurers and agents doing business in those markets.

The system today works, and today in fact the property and casualty industry is sitting on record surpluses with loss ratios better than they have been in the last 30 years. The draft SMART Act

incorporates unacceptable levels of Federal preemption that we believe would create both legal and practical problems for the insurance industry and its customers. A thorough analysis of the SMART Act by 117 insurance regulatory experts from your home States identified concerns where the bill would preempt many important State laws to protect consumers.

Federal preemption of State insurance regulation denies your congressional constituents the benefits of important State services and protections, as has already been proven in existing Federal programs, such as FEMA in its administration of the National Flood Program, and ERISA, through its taking away State authority to assist your constituents.

Unlike banking and securities, insurance policies are inextricably bound to the separate legal systems of each State. The policy itself is a contract written and interpreted under the laws of each State. When a property and casualty or life claim arises, their legitimacy must be determined according to State legal codes. State courts have more than 100 years of experience in interpreting and applying these State laws.

Although the NAIC and the States can accomplish most modernization goals without Federal legislation, there are four areas where new Federal laws are needed to help State insurance regulators do our job even better. One, to give State insurance regulators access to the FBI's criminal database in the same manner as Federal banking and securities regulators. Two, to protect the sharing of confidential regulatory information among Federal and State banking, securities and insurance regulators. Three, to amend Title 31, USC, section 3713, to assist State insurance company conservation, rehabilitation and liquidation. And four, to restore the Federal income tax exemption for certain insolvent insurance companies.

And, of course, I would be remiss not to mention our own strong support of the important TRIA initiative to protect consumers in all of our States.

The NAIC wants to play a positive role in helping the House Financial Services Committee evaluate the draft SMART Act by providing technical assistance as regulatory experts and policy input as State officials. However, the NAIC cannot support Federal legislation that includes broad Federal preemption of State consumer protection laws or Federal supervision of State insurance regulation.

As the SMART Act has not yet formally been introduced as a bill, it is premature for the NAIC to take a position to either support or oppose it. The NAIC and its members have cooperated fully over the years with important inquiries by Congress into the adequacy of the State regulatory system. We believe these inquiries have demonstrated clearly that local and regional State regulation of insurance is the best way to meet the demands of the consumers for this unique financial product.

We will continue to work with Congress and within State government to improve the national efficiency of State insurance regulation while preserving its long-standing dedication to protecting the American consumer.

I thank you again for this opportunity and for your continued interest in what we believe is a very important topic, and we look forward to continue to be engaged with this committee.

[The prepared statement of Ms. Koken can be found on page 72 of the appendix.]

Chairman BAKER. I thank you for your statement.

Our next witness is Mr. Edward J. Muhl, testifying today in his capacity as a former insurance commissioner of Maryland and also a former superintendent of insurance for New York State Insurance Department.

Welcome, sir.

STATEMENT OF EDWARD J. MUHL, TESTIFYING AS THE FORMER INSURANCE COMMISSIONER OF MARYLAND AND THE FORMER SUPERINTENDENT OF INSURANCE, NEW YORK STATE INSURANCE DEPARTMENT

Mr. MUHL. Thank you, Mr. Chairman and members of the subcommittee. My name is Ed Muhl, and I very much appreciate the opportunity to be on this panel.

My background spans nearly 40 years in the insurance industry, serving in both the public and the private sectors. I was first appointed insurance commissioner of Maryland by the Democratic administration of Governor Hughes, was reappointed by a second Democratic administration of then-Governor Schaefer, and during that tenure I was elected president of the NAIC.

I was subsequently appointed superintendent of insurance for the State of New York by the Republican administration of Governor Pataki, and my wife says if I ever decide to do it a third as a regulator that I will be all by myself.

I have also served in the private sector with insurance companies, accounting firms, as well as consulting firms. Over these 40 years, I have experienced regulation from the perspective of a company official, a regulator, a consultant and as a consumer.

Mr. Chairman, I strongly suggest to you and the subcommittee members that there is an enormous redundancy of costs and procedures in the present system of regulation which serves only to add premiums paid by the consumer, and it also raises the level of frustration in trying to deal with the complexity of this process.

I am very pleased that this committee is taking the initiative to look at the basic processes that affect all of us, and hopefully you will conclude that the present system is in need of some change.

Having said that, I believe that State regulation of the business of insurance remains better positioned to respond to unique issues of both consumers and companies in certain geographic areas. Unfortunately, the difficulty remains in the inability of the present system to attain the uniformity that is necessary to eliminate the redundancy of these costs. There are simply too many independent and diverse focal points of authority in the States and the U.S. territories to be able to gain consensus. The result is a very costly and a very redundant system.

Now, I started in regulation in 1982 and have seen efforts of individual regulators and the NAIC to try to simplify the process, gain uniformity and eliminate the unnecessary. Unfortunately, there has been only limited evidence of success over 20-plus years.

Now, when I became the New York superintendent, my experience was that the New York Insurance Department was one of the strongest in the United States. It was and remains today. And, certainly, it was one of the slowest in responding to timeline issues.

For an example, we conducted a review of all 160-plus regulations to determine if any needed to be updated or were obsolete or no longer useful to effective regulation. Some of these regulations were unchanged for 100 years but were still strictly enforced by the department despite the costs and the inefficiencies.

Now, the review resulted in the elimination of 50 outdated ones, and the remainder were changed, which benefited many and certainly increased the effectiveness of the department.

Now, the career staff in many insurance departments prove every day to be extraordinary and dedicated individuals, and they take their task of regulating the insurance industry quite seriously. Many of the oversight processes are handed down generation to generation with no time available to look beyond the daily work because of the volume. The entire system needs to be looked at, it needs to be stirred to find a better way to deal particularly with the more important issues.

And, finally, Mr. Chairman, one point on rating. I served as a regulator at a time when the rating law of the State was prior approval. Then it was changed by the State legislature to competitive rating. And, finally, when I moved on to New York as the superintendent there, that State had flex rating.

Going from a prior approval to an open competition forum proved to me that competition is an effective regulator of rates, which allowed me to make better use of my limited staff resources by putting them to use in the area of market conduct examinations and other sensitive areas. It was not an easy transition, but once the competitive forces came into play and the interest of the consumers and the industry were in balance, the system worked very, very well, and I would urge a close review of the benefits of such a rating mechanism.

Now, I have had the privilege to have been asked by the committee chairman and the staff to review many of the titles of the SMART draft and to offer comment and my views as a former regulator. I applaud this committee's efforts in looking into the current system. I look forward to offering additional support, and I wish to thank the chairman and the staff in giving me the opportunity to voice my opinions.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Muhl can be found on page 123 of the appendix.]

Chairman BAKER. Thank you, Mr. Muhl.

I will start with you. Attempting to establish a consensus on the trigger required for the committee to act in an appropriate and timely manner, there have been numerous discussions over the past 5 or 6 years where the particular regulator would come forward and say, "We have this plan, and if it does not achieve the operable results we want in X years, then the Congress perhaps should consider acting."

Virtually, every one of those self-established timelines has come and gone with regularity. Is there something tangible you could see

on the horizon that if it did not occur in some fixed time clock that the Congress should then act or is it your considered opinion, based on all that has preceded us, that it is just time for the committee to go ahead, take up the bill and have a vote and just let people establish their perspective on whether there needs to be continued defense of the system we now have or take the modest step that I think the proposal that we have circulated for comment suggests?

Mr. MUHL. The short answer, Mr. Chairman, is that I am not sure if you will ever get to a point under the present system of gaining the uniformity that is really necessary. I think a lot of the things that the Congress has done in the past to generate some activity by the States to hold, if you will, the hammer and the carrot out has given the States some incentive to finally say, "Yes, we need to do something, and all of these small things and concerns that we have had in the past, we can really just ignore those and let's get to a point where we can solve the problem."

As I mentioned earlier, I am a firm believer in State regulation. I am also, though, equally concerned about the costs that are in the system that you just simply cannot get out unless you reach a consensus. In other present systems, with what I have seen over the years, it is difficult, if not impossible, that you are going to reach that consensus.

So I think a push from Congress, I think there are certainly provisions within the SMART draft that I have seen and offered my opinions on, that certainly will do that, giving the States opportunities to say finally, "Here is a timeframe, you need to do this. It makes good logic and sense. It is going to ultimately benefit the consumer as well as the companies themselves. So you really should do this," giving the States an opportunity to accomplish that on their own but drawing the line somewhere, and that somewhere would be a 2- to 3-year period. I think that is going to serve well to try to advance some of these issues that are very important.

Chairman BAKER. Well, you have mentioned the carrot-and-stick approach. I regret to inform you they have eaten all our carrots. I mean, we have got no more time left.

Mr. Serio, in prior discussions in your former capacity, we had discussed what and when. I am just trying to get the day to a point where we establish the line Mr. Muhl was talking about. I think it is time to draw it and to act on a bill and let members take a position on the proposed reform.

Given this subcommittee's work only, 20-something hearings, meetings, discussions, we have circulated the draft to every stakeholder we can find, I have got all sorts of letters establishing all sorts of perspectives, do we need to do anything else or is it time to take up a bill, in your perspective?

Mr. SERIO. In my view, the SMART process has allowed the coalescing of all these issues and all these discussions and all these positions to come into one place.

As Mr. Muhl mentioned a moment ago, the regulatory review that we did in New York when Governor Pataki first came into office was a thorough process. I was Mr. Muhl's first deputy at the time, and it went beyond just identifying the regulations that were old or obsolete, it was getting them actually off the books on the

regulatory side but then also going back to the legislature and saying the underlying legislative authority was no longer necessary.

The SMART process has given us that same type of discipline that we went through back in 1995, that it was this thorough baseline review. And, look, a lot of people did not like the regs that we were taking off the books or did not like the “desk drawer” rules that were being abandoned because everybody has their own little piece of this. But when we told them what the overall and the overarching purpose of this was is to focus on those things we really need to do, we really got some consensus on that, and the process under Executive Order number 2 turned out to be a tremendous success.

I think you can equate that experience with what the SMART process has done, but now it is time for people to start making some baseline decisions about, Okay, what can they go for, what can’t they go for? Maybe we put this into two steps instead of one step, as I would suggest on rate regulation, for example, taking a step to flex before you get to competitive rating, but let’s make that call now.

Let’s figure out what can we do and let’s get it done, the low-hanging fruit that I talked about, things that I think everybody at the table can agree on, and I think Commissioner Koken also mentioned a number of things that there are not disagreements on. That should be done, and I think that the SMART process can show a real positive yield by getting some final decision-making done on those issues that we can at least agree on.

Chairman BAKER. Thank you. My time has expired.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

In my opening remarks, I discussed the need for the committee and the House to get our priorities in order and particularly resolve the question of terrorism risk insurance. I know that the chairman of the subcommittee shares my interest in seeing this process move along.

Anyone on the committee who wants to, tell us whether or not you think this terrorism risk insurance is essential and whether it should be extended and what type of priority is it?

Diane?

Ms. KOKEN. Well, the NAIC is fully supportive of extending TRIA, and we believe that it is critical and essential and in fact also recommended that group life be included in any extension. We have concerns about the ramifications on consumers, small businesses, large businesses alike if in fact this is not extended.

Mr. KANJORSKI. Thank you. Does anybody else want to voice an opinion on that?

Yes, Mr. Pickens?

Mr. PICKENS. Mr. Chairman, I certainly would agree that TRIA should be extended. That has been NAIC’s position for a number of years now. Adding group life at this time I think makes perfectly good sense, and I would just address Mr. Kanjorski’s concerns.

I do believe TRIA is certainly a more urgent issue at this time, but I know all of you ladies and gentlemen are capable of walking and chewing gum at the same time, and I think you can deal with

the TRIA issue and also hold a hearing like this one looking forward and again appreciate the opportunity to be here.

Mr. SERIO. Mr. Kanjorski, I got faked out by that question the last time I was before you when you asked pretty much the same question, but then you followed it up with, "Well, if you are coming to us looking for TRIA help and for financial support, why are you telling us that we cannot do insurance regulation," and so I will not take the bait twice.

But I will say this: I mean, clearly, and this is something that we have discussed with the New York congressional delegation many times over, and I think New York is clearly in the forefront of support for TRIA extension, but I take your point seriously about this idea of why can't we do these things together. We can do a TRIA together and work it out, and the States and the NAIC specifically provided much of the technical support behind the TRIA bill and was also responsible for a lot of the implementation of TRIA components in terms of working with the industry.

Likewise, when the Fair Credit Reporting Act came up for renewal a year or 2 ago, there were some people that got very nervous about the idea of a Federal preemption and making it permanent. Well, once we sorted through that at the NAIC, we came out supporting the permanency in the preemption on fair credit reporting, because that was something that really had a uniform basis across all State lines.

So I think the idea that TRIA is one of those manifestations that we can use to show that we can do this on a uniform basis, that it is not just a terrorism act for New York or for Washington, D.C. or Chicago but it is something that we need to do on a uniform basis the same way across all State lines, not only helps support the idea that TRIA needs to be extended but the fact that the Federal Government can actually work in concert with the States and can create some of these uniform standards.

Mr. KANJORSKI. Very good. I just want to add to that comment, though, that we all are aware that the delay that is occurring out there is a tremendous blockage, and I think it is a challenge maybe to the six members of the panel.

You should show us the capacity of the industry to come together and alert the leadership in both parties in the House and the Senate that this is intolerable, that we have nine more weeks left and then we are not going to have terrorism risk insurance in the United States, and the destabilizing nature of that to the economy as a whole and to the construction industry and potential technical defaults that are going to occur out there are huge.

So I guess I will not take any more time, other than to challenge the panel. We cannot seem to break the loggerhead or the delay, and we are certainly encouraging the industry to come together and show your ability, at least on this single issue, to work together to help us get something positively done. So take that as a challenge.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

Obviously, we had a lot of testimony with six of you here, and I tried to listen very closely. If we could just for a moment set aside the argument of preemption and federalism, I would like to focus on the price control issue. And just as a matter of public policy, is there anyone on the panel who wishes to share with me why price controls are necessary or even helpful to the consumers? I can see where they may be helpful to the producers, those who are marketing, but why if we have a competitive marketplace, why are they necessary or helpful?

Mr. Serio, please, you want to—

Mr. SERIO. I will start with that, and it goes back to something that Mr. Muhl referred to, the breakout between prior approval of rates, flex rating and open competitive rating.

We had an interesting experience in New York that jaundiced me a little bit about a direct move to open competitive rating, and it happened in a part of the auto market that a lot of people do not see on a daily basis. We actually have open competitive rating in the livery market. You file a rate and you can charge anything within that filed rate. And the taxi companies, the taxi insurance companies got into a very overheated, competitive price war.

Now, first of all, for the financial regulators, that becomes a very difficult thing to manage because you have to make sure that there is not money just there today, and I understood your point earlier about deregulation in other industries, but those other industries do not make promises for 5 years or 10 years down the road. They deliver a product, that product is delivered well, and pretty much the economic transaction is complete. Well, you have to make sure that these companies have got this money somewhere down the road.

Well, anyway, delivery insurance companies got into this fierce competitive battle in this open rating system. All brought rates down very far only to find out that the rates were inadequate. And when we started to tell them they had to start bringing those rates back up, they came in and started asking for rates not just back to the rates they had filed but rates on top of that. So there were some companies that had a vicious price war where rates went down 30 or 40 percent but within 2 years rate requests in the 100 percent range were being asked for.

Now, to go from prior approval to competitive rating without a mid station like a flex rating system where you can start to gauge what the competitive environment is and what it will accommodate, I think that is a very important first step to take.

Mr. HENSARLING. And I think I understand the argument in favor of some type of transition, I understand that, but I am trying to understand does anybody favor the ultimate goal of being necessary to protect the consumer to have price controls since arguably if I am buying a car or a hamburger or anything else in society, with the exception of those handful of items that have traditionally been viewed as natural monopolies, we allow market forces to "protect me." My observation is that they work pretty well.

Yes, ma'am?

Ms. KOKEN. I would also point out that part of the economic incentive or disincentive can be that in many of the coverages in the personal lines they are mandatory coverages, which really throws

a bit of a wrench into the competitive model. Auto insurance is not something that people have an option in most States to purchase; they must purchase. But the overarching concern also needs to be, and certainly from the regulators' perspective is, that in addition as we look at the whole equation and the inadequate excess of our unfairly discriminatory rate aspect, what we are primarily focusing on is the solvency issue.

As was pointed out by Mr. Serio, because you are buying a promise today that is not going to be paid off for a substantial period of time and there are and can be incentives to undercut and charge inadequate rates as well as excessive rates, we do believe that there needs to be a balance for that overall—

Mr. HENSARLING. I understand the solvency argument. I thank you.

Mr. Shapo, I sense that you may have a different opinion.

Mr. SHAPO. Yes. The argument about a mandatory product is something I have heard before, and it is a mandatory product, but I am not sure why that would change the laws of economics. If it is an inelastic demand curve, I would think that would mean we were more interested in making sure there was adequate supply, and price controls, if they do anything, choke off supply. So I mean, I am not aware of any economic study that would suggest that there needs to be price controls for a mandatory product.

Like I said, I am not an economist, but I think that if we were going to adjust because of that, the last thing we would want to do is turn to measures which would reduce supply when everybody needs the product.

Also, we do not regulate the price of food and we have to eat. There are all kinds of things that are necessary in life which we do not do price controls on.

Mr. HENSARLING. Thank you. I see my time has expired.

Chairman BAKER. I thank the gentleman.

Mr. Israel?

Mr. ISRAEL. Thank you, Mr. Chairman.

Let me join Ms. Kelly in welcoming Mr. Serio who did an outstanding job as the superintendent of insurance in New York.

We had an interesting meeting of the Democratic whip team this morning with Mr. Hoyer, and some of the discussion was about an outbreak of partisan eruption in the Judiciary Committee, and Ms. Wasserman Schultz stood up, who is a member of the Judiciary Committee, and said, "You know, I am on the Financial Services Committee, which is one of the most bipartisan committees, one of the most constructive committees. We always find a way to work together."

And that certainly is true. We found a way on GSE's, we found a way on SCRA, and hopefully we will find a way on TRIA, because as valuable and as important as this discussion of Federal regulation of insurance may be, we can walk and chew gum at the same time. We need to address TRIA. It is critically important.

When I talk about TRIA at home, most people's eyes glaze over, and so I would like—and perhaps Ms. Koken can lead us off, because I know the NAIC has passed a resolution on this—what would happen if we did not extend TRIA? What would the implications and ramifications be if we only focused on Federal optional

charters and did nothing to TRIA by the end of this year in the nine legislative weeks left?

Ms. KOKEN. I think that not acting on TRIA is going to create difficult market issues, because in fact in a free, competitive marketplace on the issue of terrorism coverage, the carriers will choose not to cover it. There are certain circumstances in which they will be required to cover it, like workers' comp, which cannot be excluded from policies

And so I think that we are likely to see impacts on small employers, large employers perhaps with concentrations in one location that cannot find workers' comp coverage or in the building sector where it is difficult based on the location to get the proper liability coverage. And I think, therefore, it will have an economic impact on the communities that we all live in.

Mr. ISRAEL. Thank you.

Mr. Serio, would you comment on that?

Mr. SERIO. Yes. The superintendent between Ed Muhl's tenure and my tenure was our friend Neil Levin, who liked to say that the past is prologue. I do not think there is any guessing game about what is going to happen, because we already saw it happen.

Now, in the 14 months it took between 9/11 and the passage of TRIA 1, you already saw the disruption that occurred in the marketplace. There were not only economic disruptions because coverages were constrained and because prices went up, but you also saw the industry going to State regulators or State legislatures saying, "We need relief from the standard fire policies," the so-called New York standard fire policy that had allowed for coverage for fire following any kind of an event, including a terrorism event.

That same dynamic is going to occur all over again. You are having these discussions not just on the economic impact if TRIA does not get extended but also what are the policy implications, and that is a discussion going on in a lot of places right now, and I think you will end up having the same type of result. I think what occurred in 2001–2002 is likely to occur again if TRIA is not extended, and that will be that you are back to this issue again of each State individually having to take up the question about what they do for their own market.

And bringing it back to the issue at hand today, TRIA allows uniformity across State lines so you do not have a depletion of things like standard fire policy, so that you do not have a further mismatch of policy regulations around the States.

Mr. ISRAEL. Thank you, Mr. Chairman. I yield back my time.

Chairman BAKER. Thank you, Mr. Israel.

Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman.

Commissioner Koken, it is not any secret, in the press or here on the Hill about the relationship between the NAIC and Congress. This has not been a very good relationship. I am wondering if you can explain to the committee what steps you have taken to improve that relationship in terms of personnel and in terms of outreach?

Ms. KOKEN. Well, I would first point out that the NAIC and the officers have been committed to continuing the dialogue and being available for any Members of Congress at any time. And, in particular, I think what you are referring to is that last year at the

NAIC there was a change of officers where the president left in mid-year, in June, and I was not elected to fill that vacancy until September. We took steps at the NAIC, first of all, to change our bylaws to put in place a president-elect so that we could assure that there would always be continuity in the NAIC in our relationships and our dialogue, and in fact the president-elect is here with me today.

So that was certainly one step, but we recognize that we needed to be able to respond to this committee on the draft proposal that was put together, and so we put together a team of 117 regulators to go through each of the titles and develop a response.

In addition, I would say that the head of our Washington, D.C. office also left and we were in the process of replacing that individual. We do have someone who will be officially starting on July 1st, and so certainly to the extent that there has been a perception of our lack of dialogue on this, we remain and are very engaged, have been engaged through over a 1,000 hours of work in analyzing this important piece of draft legislation, and certainly we remain willing to discuss and meet with any members of this committee on any insurance issue, because we do believe that we possess a level of technical expertise based in our State experience.

Mrs. KELLY. I thank you for that response. I think the NAIC is really too important to the insurance industry for the doors to be closed between us.

Ms. KOKEN. I agree.

Mrs. KELLY. And for some time I felt that they were.

I would like to just pose a question to the entire panel. Chairman Greenspan has said before this committee that the market for terrorism reinsurance just does not really exist, and I would like to know from each of you, would you prefer a Federal Government run reinsurer or a sponsored entity with a corporate structure?

Let's just start with anybody who wants to pick up on that.

Why don't we start with you, Mr. Pickens?

Mr. PICKENS. I certainly would prefer private market solutions, and I believe there are some out there. In fact, Ernie Csiszar, the NAIC president last year in 2004, has recommended some very good private market solutions for the problem of terrorism risk insurance and catastrophes in general, and one of those is a tax-free catastrophe reserve, passing a law that would allow insurance companies to place money aside, put money away for a rainy day, if you will, when you have a catastrophe or a terrorism attack. That is something that would be very helpful.

There are also other mechanisms in securitization that are good private sector approaches. But in the meantime, I think we truly need to reenact TRIA, because it has provided a safety valve for the market, and it does give reinsurers some relief and keeps them in the game, if you will.

But there are some good private market approaches. I would like to see those in the long run. Whether or not those can be included in the current TRIA bill, I do not know, but certainly prefer a private sector approach as opposed to a government-run program.

Mrs. KELLY. Mr. Pickens, I want to point out one thing: If we just have a mere extension of TRIA, it does not solve anything. So we really need to fix this problem.

Anybody else on this panel want to respond to me—Mr. Serio?

Mr. SERIO. You may need the same carrot-and-stick approach that we were talking about with respect to modernization of insurance regulation for the industry. It is a little perplexing that over the last 3 years since TRIA has been in effect that there has not been a private sector solution percolate to the top of everybody's attention, and I think it is because at the end of the day TRIA is not really an insurance industry bill; it is an insurance consumer bill.

And so maybe we need to reconnect TRIA to the insurance industry and give it kind of that carrot-and-stick approach that we want to foster the development of a uniform catastrophe-reserving type of mechanism, whether it is for terrorism or otherwise, because if you are talking on the east coast or in the Gulf coast, you can use this for hurricanes as well, particularly after last year's events in Florida.

But there needs to be some kind of a compulsion to get the private sector to bring some of those ideas that Mike referred to the surface. And I think a bill that kind of broaches that issue that way will get the industry reengaged in that discussion in a meaningful way.

Mrs. KELLY. Anybody else want to tackle it? Yes?

Ms. KOKEN. Well, I would suggest that putting in TRIA again for, say, a 3-year period would allow the marketplace and the industry to have the time necessary to put together a model, and I know there are discussions that are ongoing now, but put together a model that would work to create a private long-term solution. Because I agree with you, it would remain a stopgap, but I think it is a critical stopgap, and then there needs to be some time and effort put into a longer-term solution.

Mrs. KELLY. Ms. Koken, it has been 3 years since we have had TRIA, and in 3 years we have people coming back saying, "We need 3 more years." There is no guarantee that in 3 more years there will not be people coming back saying, "We need 3 more years." There is a time when we need to have closure on this.

So I respectfully disagree with the fact that we need 3 more years. An extension has to have an end at some point, because the Federal Government cannot always be expected to be the insurer of first resort.

Thank you, Mr. Chairman.

Chairman BAKER. Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

I do have some questions about the proposals to eliminate State price regulation. My concerns are about some of the other factors that go into underwriting decisions, about what price to offer to consumers, and my understanding is that the draft document would eliminate a lot of the State classification systems.

I think, Mr. Shapo, I think you perhaps have spoken most forcefully on the panel opposing State regulation of premium insurance. Would you also eliminate the State regulation of what may be considered in underwriting? Some things I want to be considered. I want driving records to be considered in automobile insurance. I do not want the neighborhood someone lives in to be considered. Would you also repeal all of that State regulation of what may be

considered in underwriting in the prices that are offered to consumers?

Mr. SHAPO. Representative, most States have an unfair discrimination law that starts with the presumption that if a rating factor is actuarially justified—

Mr. MILLER OF NORTH CAROLINA. I am sorry, speak up.

Mr. SHAPO. I am sorry. Most States have a rating law that creates a presumption in a statute, and it has been affirmed in case law, that actuarially justified underwriting and rating factors are presumptively legal. Most States allow territorial rating or some form of territorial rating.

I would start with the presumption that if the factor is actuarially justified, it should be allowed, and the presumption could be rebutted and overcome. For instance, most States have laws that prevent—in fact, all States have laws that prevent using race as an underwriting factor. And if there are other factors that are considered socially noxious and unacceptable, then I think that the system now allows that.

And I think it is a different issue than what I was trying to testify about before. I was talking about laws that give the authorization to review rates for inadequacy and excessiveness, which, essentially, today is basically used an excessiveness tool when the focus used to be inadequacy.

As I said before, I have a strong presumption about that, and I do not think the amounts, the levels, the number should be regulated, and I would start with a presumption that—

Mr. MILLER OF NORTH CAROLINA. And you do support the States' ability to set classification systems of what information can be considered in setting rates and what rates are being offered to consumers.

Mr. SHAPO. I would certainly support some oversight body's ability to do that. And I think that will be something that this committee will have to grapple with, whether such exceptions to actuarial justification are okay, whether that is a decision that needs to be made at the Federal level or the State level. I think some oversight legislative committees and legislature should have the ability to declare certain factors socially noxious and unacceptable.

Mr. MILLER OF NORTH CAROLINA. Okay. Anyone else?

Mr. Pickens?

Mr. PICKENS. Yes, sir, just to follow up on what Nat said. All States do have unfair discrimination laws which prohibit certain types of underwriting, and my understanding, from my reading at least of the SMART drafts, that that would not be adversely affected.

Now, just one cautionary note, though: I do not think that any regulatory body wants to get too much into the details of underwriting, and the reason for that is you can adversely affect solvency. For example, if there are—anything that increases the risk, if there is not an increase in price associated with that, then losses will increase and the company will lose money, and the company will eventually go out of business or have solvency problems.

So I do not think you want to play politics, if you will, with underwriting, other than the fact that in insurance we want to prohibit unfair discrimination, price increases based on race and other,

as Nat said, socially obnoxious or unconscionable type factors. I would caution that we do not want to get too much into underwriting decisions, because if we do, what I think may be fair and you think may be unfair becomes subjective at some point. And also, again, ultimately, if it increases the risk, there has to be I guess a corresponding increase in the price or you will have solvency problems and lack of availability.

Mr. MILLER OF NORTH CAROLINA. Well, the problem with your answer is I cannot tell you what you have said. For instance, do you think it is actuarially sound to distinguish premiums based upon the income of the insured in homeowners or automobile insurance?

Mr. PICKENS. Based on the income of the insured?

Mr. MILLER OF NORTH CAROLINA. Or credit history. Income or credit history of the insured.

Mr. PICKENS. Now, credit history is something that obviously has been shown that there is a corresponding—on an actuarially sound basis, there is an increase in the risk of somebody that has a high credit score.

Now, what we have done using the NCOIL model, the National Conference of Insurance Legislatures, State regulators, and we passed it in Arkansas, was a model that prohibited certain factors being considered in the credit score. That is certainly justified. If somebody the has had medical bills that were beyond their control, things of that nature, that is justified.

Basically, when I say, "increase the risk," what I am talking about, as Nat said, if you understand the term, "actuarially sound," if you do not keep rates actuarially sound, you will end up with solvency problems with companies.

Mr. MILLER OF NORTH CAROLINA. What I understand actuarially sound is that there really is a difference in risk based upon these factors, which I understand, but some of the limitations on classification systems, as Mr. Shapo seemed to acknowledge, was that, yes, some of them may be actuarially sound in the sense that, yes, these two different people may actually pose a different risk. What makes the risk different is not one we want to allow a distinction based upon for societal reasons.

Mr. PICKENS. And, again, most States do not, and that is what I was saying, socially unconscionable things. Income is not allowed as an underwriting factor, race is not allowed as an underwriting factor. There are a number of things that are not allowed at this point. But I guess the question I ask is, where do you draw that line, and I think you have to be careful that you do not step over that line, because when you do you end up with solvency problems with companies.

Chairman BAKER. The gentleman's time has expired.

Mr. Tiberi?

Mr. TIBERI. Thank you, Mr. Chairman.

Chairman BAKER. Excuse me, I made an error. I passed over Mr. Manzullo.

Mr. TIBERI. I think that is correct.

Chairman BAKER. In the regular order, he is next.

Mr. TIBERI. Thank you.

Chairman BAKER. Mr. Manzullo?

Mr. MANZULLO. Thank you. I appreciate that.

I have, actually, more comments than questions. Coming from Illinois, I appreciate the fact that there is a lot of competition involved in insurance. When we decided to shop for insurance on our farm, even though farm casualty insurance has gone up substantially in the past several years, we noticed a lot of competition going on, and there are some surprising differences in rates.

But I also noticed more in automobile liability insurance. We have 4 cars and 5 drivers, and 3 of those drivers are ages 17, 19 and 21, and we work with a very aggressive agent in Illinois who is continually combing the market to get the best rates. And I just laugh when I see some of these national advertisements where you call and they are not centered in Illinois, and I call the 800 number and they think they are giving me a deal, and one actually quoted me a rate that was twice what we are paying now, which we think obviously is too high. But that is only because of competition. It has to be.

So anything that would interfere with the ability of States to allow competition would be difficult for me. I have a federalist issue here, and that is States have the right, as far as I am concerned, to regulate or not regulate. It is not an issue of the Federal Government. Where I think the Federal Government has a role is with regard to products. I have seen where insurance products are very similar to banking products, investment products, and the banks can get those approved lickety split, and sometimes the insurance products going through the individual States can take so long that by the time the approval occurs, that product has worn out.

And the reason I could see some Federal jurisdiction with regard to the product is the fact that these products cross State lines, they are all over the place, whereas an insurance policy is centered where the cars, where the individual lives or where their home is. Any comments on that?

Yes. However you want to take it. Well, go ahead, both of you, don't fight.

Ms. KOKEN. Well, I think you raise some valid points and certainly we have a great deal of concern about the issue of encouraging competition. For example, in Pennsylvania, we do have 1,700 companies that write insurance, but on a national level, we are concerned about speed-to-market and getting those products out quickly. And we looked at this in different ways, and one of the things that we did develop is the interstate compact which we believe would provide a single point of filing for life annuity, long-term care policies that would address that concern for those products.

We passed the interstate compact in 2003, in July, and in the first year we had nine States that passed the compact. This year, we have had six States so far, plus we have Texas and Vermont that have passed it but the governor has not yet signed it. So we are almost up to 17 States and 23 percent of the premium. When we get to 26 States, or 40 percent of the premium, the compact will be implemented. So we recognize that.

But for property casualty products, we have done a great deal of work in the States in setting up checklists and developing a tech-

nology-based filing program, which is SERF, and I can tell you that in 2001 there were 5,000 filings on SERF, and so far this year there have been 210,000 filings on SERF.

Mr. MANZULLO. Let me hear what Mr. Shapo has to say on it. Thank you.

Mr. SHAPO. Thank you, Representative.

I wanted to follow up on the question of what Congress' role would be in overseeing this. I think when it comes to rates that it is not an impingement on federalism or if you have a strong belief in State rights, because in many ways the prevalent rate regulation today is a result of congressional action itself. Congress incentivized the States to encourage collusion and to pass rate regulatory laws 60 years ago. And in large part today's system grows from that. So I think it is not Congress going any further than it has gone before. It has no further intrusion on States' rights.

Also, it clearly affects interstate commerce, rate regulation. There are studies that argue that rate regulation has led to the industry being less capitalized, not as much supply available, which clearly affects interstate commerce when the practices of some States.

Mr. MANZULLO. Well, I mean, what Congress did 6 years ago just because it is precedent does not make it right.

Mr. SHAPO. No, but—

Mr. MANZULLO. I mean, the issue is whether or not this body has the authority to tell a State or not to tell a State that it has to fix the rates or not fix the rates. I mean, either we are wholly excluded from the area or we are not, and I think it is the latter.

But what I wanted to add in there is I noticed on page 4 of the Covington testimony and page 7 of the Koken testimony is the fact that what you are trying to do is something similar to the Commission on Uniform State Laws where, for example, the uniform commercial code was adopted. There is a uniform Commission on Traffic Laws trying to get the States to come together on a consensus because it used to be bills and notes that differed by States and now I think it is Article 6 or 7 of the other uniform commercial code. Is that what you are trying to do?

Chairman BAKER. And that will be the gentleman's last question, as his time has expired, but please respond.

Mr. SHAPO. Mr. Chairman, if I might, it is not just that Congress has set a precedent generically, it is just that Congress has, in large part, contributed to the varied situation in the market today. So it is quite appropriate, I believe, for Congress to revisit its past policy decision, which had led to serious ramifications in the market, and consider whether that had a negative impact on interstate commerce.

Mr. MANZULLO. Thank you.

Chairman BAKER. I thank the gentleman.

Before I recognize the next member, I just owe members, and then I realized observers, an explanation as to recognition procedure. I have been informed by the Democrats side that members would be recognized in order of seniority. We continue to observe on our side by time of arrival, if you are here, to be recognized. So despite my insistence on uniformity, we are now beginning to look like the NAIC up here.

Accordingly, I recognize Mr. Clay.

Mr. CLAY. I thank the chairman, and seniority does have its benefits.

Chairman BAKER. Depending on where you are, I guess.

Mr. CLAY. My question is for Mr. Pickens. The SMART Act, we all know, has not been supported by consumer groups. Many have written that the SMART Act would override State consumer protection laws, promote anticompetitive practices by insurance companies and preempt State regulation of insurance rates. Why do you believe that SMART will use only the threat of preemption and not use preemption? Are there guarantees of this, and please elaborate. Additionally, please detail your opposition to the optional Federal charter.

Mr. PICKENS. First of all, I believe the reason that consumer groups are opposed to the SMART approach is largely because they would like to see the creation of a Federal insurance regulator. Some of those people, Bob Hunter being one of those, has made it very clear that he would like to see the creation of a Federal insurance regulator.

The reason that I am opposed to an optional Federal charter really is pretty simple. Number one, I believe that a State-based approach to regulation, which is encompassed to SMART, is much preferable to the creation of a new, huge bureaucracy in Washington, D.C. I do not think we need the creation of a new Federal agency to regulate insurance.

I think what you would see ultimately is—bottom line is, State regulators are closer to insurance consumers in both proximity and in their philosophies. It is easier for me to get a hold some regulator in Little Rock than it would be to get a hold of one in Washington, D.C.

I think also, bottom line, and I think one of the reasons the State legislators have been concerned and governors have been concerned, is that you would ultimately, I think, see a flow of premium tax dollars, which all of the States depend on, coming to Washington, D.C. We collect around, I think, $110 million, $112 million in premium taxes. None of that money goes to the Insurance Department in Arkansas. It all goes to run other State agencies for a number of programs. So if we were to lose a fraction of that to the Federal Government in Arkansas, it could hurt us a lot.

So that is primarily the reason I am opposed to an optional Federal charter, and I think we are all in agreement.

The reason I say the threat of preemption is what SMART poses as opposed to preemption and why I see it as an opportunity is because my understanding of SMART, of what the ultimate goal of the SMART process is, and I know we have a market that will be thrown out there very soon, but the ultimate goal is to basically take the work that the NAIC has done through the 2003 action plan, through the 2004 road map, and say, "Okay, States, here is what you all have committed to do. We are going to give you a set period of time to do to keep this commitment that you have made to us these number of years, and if you do not do it, what you already have come up with will be the law of the land." And you will enforce it, you will continue to be the enforcer.

Now, what I understand there is some misunderstanding about or some disagreement about is really on what the details of the legislation are. There may be some on the committee who would like to see things in the SMART Act that are not necessarily contemplated under the 2004 road map or the 2003 action plan. So I think that is where the debate should be centered, and, again, I think it is totally appropriate to throw down this bill as a marker to get everybody to come to the table and let's talk about it.

Mr. Chairman, we have a saying in Arkansas, "Fish or cut bait," and you guys have it in Louisiana, and we have some more colloquial sayings that we cannot say in public. But the bottom line is, it is time to get down to business, I think, and take some action.

Mr. CLAY. Let me ask one more question before my time runs out, and this is on TRIA.

And I will ask Mr. Muhl. He looks like he wants to answer a question.

I was in favor of the immediate triggering of the make available requirement for the 2005 program year. I agree that the Federal backstop should be extended for terrorism risk insurance until the Congress, the administration and private sector stakeholders can agree on a permanent solution for problems associated with trying to underwrite acts of terrorism. I do not, however, favor a permanent government backstop.

How long do your studies indicate that the backstop may need to remain in place? Are there differences in present-day government estimates and the industry estimates regarding the amount of time a backstop is needed?

Mr. Muhl?

Mr. MUHL. Thank you. I actually have no idea how long it would take to hopefully come up with a private solution versus a Federal solution. I am in favor of, being that there is not a private solution at the present time, I know there are efforts that they are trying to get the private sector involved in that process, to get something up and running, but it does not exist right now. But I am a firm believer in just to keep the markets calm that in fact you need some sort of a solution.

My preference is to see a private solution versus a Federal solution, but, again, whether ultimately there is going to be a private solution, I have absolutely no idea. But if there is not one in the next couple of years, then I think the direction that everybody is going about not pushing this TRIA for expansion I think is the right thing to do, but I think it is appropriate to do it now because there is no solution.

Mr. CLAY. Thank you for your response.

And thank you, Mr. Chairman.

Chairman BAKER. Mr. Tiberi?

Mr. TIBERI. Thank you, Mr. Chairman.

Mr. Covington, good to see you. We miss you in Ohio.

I apologize for missing your testimony, but let me harken back to June of 2001 when Chairman Oxley had asked you a question that if Congress set a goal of 3 to 4 years for achieving comprehensive uniformity by the NAIC for product approval, could the NAIC meet that goal, and you answered, yes.

Can you tell me what the progress has been at the NAIC over the last 4 years since that question was asked? And is there, in your opinion, comprehensive nationwide uniformity?

Mr. COVINGTON. Thank you, Representative Tiberi.

As you know, I have been out of NAIC for 2 years, and so I might defer that question to Commissioner Koken as to the progress that has been made over the last 2 years, but I will note that in my testimony I noted that the NAIC adopted a commercial lines rate and form model, and to this date no State has adopted or, to my knowledge, even introduced that model. So I think the record speaks for itself with regard to that. And there appears to be, as I indicated, little interest in addressing the personal lines rate modernization issue.

So, again, I think because of the challenges and the obstacles noted in Nat Shapo's testimony and in my testimony, that it will be difficult, if not impossible, to achieve those particular reform initiatives under the current framework.

But I would defer the progress question to Commissioner Koken.

Mr. TIBERI. Okay.

Ms. KOKEN. I would comment that the State regulators are very concerned about always balancing the interest of fee markets against the importance of the consumer and protecting that consumer in all circumstances. But I would say that I believe that the States have made huge progress in establishing checklists and feeding off the approval time within each State as well as our initiative for life and health of the compact. So I think that there have been a lot of changes.

I can tell you that I talked to a major company recently to ask if they were going to support the compact in New York, and they said to me that with the new checklist and the procedure in place, an approval time of 30 days would actually be going backwards because they are getting much quicker approvals. So I think there has been tremendous progress in both large and small States across the country, but totally focused on what they believe is in the best interest of the consumers in their State.

Mr. TIBERI. Just a follow-up, Commissioner, do you think that the SMART Act, by setting deadlines and standards for States to meet, will help achieve nationwide uniformity quicker?

Ms. KOKEN. Well, I am not sure that nationwide uniformity is necessarily the goal across the board. The goal is to protect the consumer, that is our number one goal, and in some cases that means we are looking for uniformity, in some cases it means uniformity of process and not uniformity of law.

There are certainly dramatic differences around the country, and each State faces different types of risk for their consumers. I mean, we do not have coastal issues in Pennsylvania but we have mine subsidence issues which they do not have in Idaho. So we think that pursuing the standard of uniformity across all lines, across all States is not necessarily the approach as much as streamlining, improving, modernizing and continue to evolve the regulation of insurance.

Mr. TIBERI. My sister, who lives in Cincinnati, a consumer, butting the district of my colleague to the right here, would, I think, benefit from uniformity in terms of being able to buy prod-

ucts in Kentucky versus Cincinnati. Isn't the advantage to the consumer if there was more uniformity in that sense?

Ms. KOKEN. Well, it is a balancing factor. There certainly are benefits to having uniformity, but, certainly, the tort law, the contract law in Kentucky, I would suspect, is different than the laws in Ohio. And the State insurance departments and the State policies have to reflect those particular issues in each location.

Mr. TIBERI. Thank you.

I yield back, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman.

You know, I just cannot support a legislation that does not provide strong consumer protections especially against discriminatory practices, and I have some concerns that the SMART Act would not and does not currently provides protections against insurance redlining and other discriminatory practices. There are many States that do.

Each of you are either present or former directors or insurance commissioners, and I would like to ask you, given that, given my concern about the lack of discriminatory protections in this bill, do you believe that the SMART Act should adopt stronger protections against discriminatory practices?

You first, Mr. Shapo.

Mr. SHAPO. I was really asked to testify about competition generally, only specifically, not on the draft of the bill, but I do believe that the bill, in its draft form anyway, specifically preserves unfair discrimination laws with respect to the standard list of prohibitive factors, including race.

Mr. SCOTT. Okay.

Mr. Serio?

Mr. SERIO. Yes. That is my reading of it as well. Let me take your question from a slightly different perspective also. The consumer protection issue is the greatest thing to wave around, and we all do it. When we were in office, we made sure that the consumer was being protected. You have a responsibility as public officials to make sure the consumer is being protected. But there are a couple of different ways to get at that issue of consumer protection.

When Ed and I first came into the insurance department in 1995, we were told that New York does not allow certain types of products because they are bad for the consumer. Well, two things we found out. Number one, there were consumers who actually wanted some of the things that we were prohibiting, and, number two, if they were not getting it from us, they would go right across the line and go and get it someplace else.

So one of the things that I think uniformity would allow, and I think the deliberative process behind the SMART bill would be to try and create a uniformity so you have the same level of consumer protection from one State to the next, that instead of having these varying degrees, and it goes back to the previous question also, the varying degrees of consumer protection or the notion of consumer protection, you actually have one set of uniform standards across the lines.

Particularly for people who live in media markets that intersect two or three States at a time, they have no idea what the rule is in one State versus the other. All they know is that, "I want that kind of coverage, and if I cannot get it in my State, I am going to go across the State line and get it someplace else."

And so you have this issue, and I think the SMART bill already reflects a lot of that because it is trying to create a foundation of the protections that are already largely afforded by all of the States, redlining being one of them. That is uniform across all the States. Gender discrimination, age and demographic and race discrimination are all prohibited on most lines of insurance coverage, and I do not think that is really going to change with the enactment or whatever the final SMART bill might look like. And we know that is not going to happen because you will not let it happen, because no public official is going to allow the undoing of redlining laws.

Mr. SCOTT. Ms. Koken, I believe you are the only sitting commissioner of insurance among all of you; is that right?

Ms. KOKEN. Yes.

Mr. SCOTT. Could you provide a comparison between the Illinois insurance regulatory environment and the SMART Act? Specifically, what I am getting at is, does the SMART Act provide the level of consumer protection, especially against discrimination, that your State provides?

Ms. KOKEN. Well, I guess it is my understanding from the review that was done by the review committee, the group of regulators, that there were Illinois regulators that looked at the SMART Act provisions with regard to a comparison of Illinois. I did not personally do that.

And there were lists, I think, of around 12 specific consumer protections that the Illinois regulator believed would be lost to consumers if in fact the SMART Act was passed in its current draft proposal.

Mr. SCOTT. Good. Thank you very much for that answer.

Let me ask about rate controls, another issue that is on my mind. What is the effectiveness of rate controls now in the States? Are they holding down rates or are they reducing competition? And would national deregulation increase competition or encourage consolidation within the insurance industry?

Chairman BAKER. And that will have to be the gentleman's last question, as his time has expired, but please respond.

Mr. SHAPO. I think that it is well established, generally, in scholarly literature and in front of this committee in previous hearings that price controls do not have the effect of lowering prices, and in fact they have the effect of greatly limiting availability. They choke off supply.

The most extreme example is New Jersey which had the most aggressive price controls with rate rollbacks and very tough prior approval regime. And what happened there was the carriers began to restrict how much business they wanted to write, which, in itself, explains the problem with the system.

Whenever sellers are going out of their way to try to sell less rather than more, I think it is a pretty good sign that the market is not working, and carriers pulled out of the market. And the issue

there was supply, supply, supply, which was badly impaired while rates did not lower, and it became a fact of life there that well-qualified risk could go out looking for coverage for weeks without getting it. People could walk into an agency with a terrific driving record and excellent credentials otherwise and not get coverage, which is a perverse result.

Mr. SCOTT. Ms. Koken?

Ms. KOKEN. I guess I am not a New Jersey regulator, however New Jersey does border my State, so I have some familiarity, and I believe that Mr. Shapo is talking about their auto marketplace. And in fact it was more than price restrictions that created the problems in New Jersey. It had to do with the fact that they also regulated by providing that the entire State would have the same territory rating. So what that encouraged is people in the rural areas were actually subsidizing people in the urban areas, and so it paid for companies not to write in the urban areas because they were getting more per customer in the rural areas. And then they required all companies that write there to participate in their insurer of last resort, which created more problems.

And so really it is a classic case of essentially overregulation ultimately choking the market, but I think that I cannot say that price restrictions were not a factor but they were certainly not the only factor in what happened there. And we certainly believe that the review of rates to assure that they are not inadequate or excessive or unfairly discriminatory is an important consumer function that State regulators do in each State.

Chairman BAKER. The gentleman's time has expired.

Just for the sake of clarity of the record, Mr. Scott, I want to, not taking your time, just add a response to your question relative to SMART Act provisions and discrimination practice. It occurs in Title 16 of the proposal, Protection of State Antidiscrimination Provisions. We have chosen to rely on the State consumer advocacy process to address those general concerns, and specifically, it says, "Nothing in this title shall preempt any State statute, regulation or order to the extent that it prohibits the use of race, color, religion, creed, ethnicity or national origin as an underwriting or rating factor or classification."

To the extent that any State now protects consumers from those ill-advised approaches to market regulation, the SMART Act makes clear the States are in control of those concerns.

Mr. SCOTT. Thank you for that clarification, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Scott.

Mr. Davis?

Mr. DAVIS OF KENTUCKY. Thank you, Mr. Chairman.

As Mr. Tiberi mentioned, I have a district down south from him in the Commonwealth of Kentucky, spent my business career helping companies simplify their business processes, come to common standards of information to be able to share back and forth, and the benefit was invariably reduced cost, reduced transaction time, improvements in customer service. But I come to this hearing as not an expert in insurance but really with a question.

The commonwealth, we have in place a system that is very similar to the SMART approach. It has a competitive rating under certain circumstances which include a flex band, and for example, for

forms, all forms need to be filed with the State but they are deemed approved by default unless they are specifically disapproved within the waiting period of 60 days.

My first question, our commonwealth has a competitive stable property and casualty insurance market, which incorporates a file-and-use system for forms filing. In other words, companies can file their products with the State and then go ahead and use them. SMART incorporates on a nationwide basis a file-and-use system for forms review, and my question, just from our local experience, and I would like Mr. Muhl to comment on this first, do you think that that will reduce filing time and bring improvements to the marketplace?

Mr. MUHL. I believe that it will. I am sorry, did—

Mr. DAVIS OF KENTUCKY. Go ahead. Mr. Muhl first and then Mr. Covington can comment.

Mr. MUHL. I believe that it will reduce the time involved in getting products out on the street, being able to make them available to consumers for their purchase and use. I am a firm believer in the competitive rating system. I think a use-and-file system is good. A flex band rating is also good.

I have found, though, through my experience that in fact getting involved in a prior approval mechanism and then a competitive rating and a file-and-use system that if you create a very competitive situation, that those rates involves in that process are going to find the lowest levels. There is going to be product availability, there is going to be choice for the consumer.

And I think that kind of a process, that kind of a system is good for everyone. It is good for the industry having those products to sell, certainly good for the consumer in having not only prices that are very reasonable in, say, a lot of these products but particularly having available a lot of these products. And I think those kinds of systems if you can create it, I think everybody benefits.

Mr. DAVIS OF KENTUCKY. Mr. Covington, you wanted to add something?

Mr. COVINGTON. Yes, Congressman. Let me just be clear that file-and-use is only a name, and the relevant issue is how that system is executed. Today, we have examples across the country where States have file-and-use, use-and-file, but many view those States and some of the most price controlled rate regulatory environments in the country. And so as you move forward, I encourage the committee to explore ways how you can achieve your goals and ensure that the legislation is specific enough to ensure that any system is operated as intended.

Mr. DAVIS OF KENTUCKY. I think personally wherever we can come to common standards, especially where the industry comes together working with the States to have common standards of information, form-sharing can be very helpful.

One question I would like to follow-on with that, if a rate moved with a flex band, for example, 25 percent and it did not have to be approved by the State, my question is, SMART incorporates a transitional flex band system with a full competitive rating. Do you think that nationwide competitive ratings for insurance sectors that are stable and healthy, not in the controversial high-risk

areas, will consumers more choices, will be a better way to deal with it as well as addressing the cost issue?

And maybe Mr. Shapo would comment on that.

Mr. SHAPO. I am sorry, could you rephrase it?

Mr. DAVIS OF KENTUCKY. Do you feel that the flex band system, for example, if there was a percentage set, for example, like a 25 percent flex band common standard for—

Mr. SHAPO. Did you mean as a transition method or as an end result?

Mr. DAVIS OF KENTUCKY. Looking as an end result.

Mr. SHAPO. My presumption would be that the end result would better be competition for supply and demand, which are the most ruthless regulators in the marketplace, are allowed to work. I fully acknowledge that there may be very good reasons to phase toward that result, but my preference would be that the end result would be competition for many reasons.

I mean, I think we presume that competition is the best regulator for price throughout the economy. I am not aware of any reason to believe that insurance is immune from the laws of economics. The reasons for price controls previously in insurance had nothing to do with availability and affordability. And for all the reasons I spoke of before and got into more depth in my written testimony, I think that that should be our presumption.

And it is not entirely benign to even have a more open system, as you are describing, because it takes resources to administer that, and there are things that government must do to protect consumers.

Consumers can protect themselves shopping for price, they do it all the time, in every market. The average consumer is not an accountant, cannot figure out the balance sheet of a company. Government has got to do that for the consumer. The average consumer is not a contract lawyer. Government should be reviewing forms.

Mr. DAVIS OF KENTUCKY. I appreciate that. We saw in Kentucky how a lack of competition in health insurance areas, just as a business owner, led to a 400 percent increase in premiums for most business providers as opposed to the road to ruin was paved with good intentions.

Did you want to share something, Mr. Serio, and then Ms. Koken?

Chairman BAKER. That will be the gentleman's last question. His time has expired, but please respond.

Mr. SERIO. I will give you a real-life example of how flex rating can help and how open competitive rating can help but not from the typical perspective of prior approval. Prior approval is generally done to avoid increases of insurance rates.

New York and a number of other States have seen a significant decrease in the loss costs on automobile insurance across the board, and it has been a very positive development in automobile insurance. Yet since flex rating had expired in New York, there was no system compulsion for the carriers to start to reduce their rates. And it took the department to have to start going and prodding these guys to start to reduce their rates.

If flex rating had still been in place, I can tell you that the rates would have gone down a lot faster, as they should be. And now, only now, after 8 months of this process, has the marketplace started to gin up the competition and only because some companies are advertising relentlessly for lower insurance rates that the other guys have started to pick on to it. But it was very slow in developing because nobody felt that competitive pressure, because everybody knew they were going to have to come pass through the regulatory process in order to get any rate reduction.

If you have a flex rating system, and I think the flex protects from the rate going too low where it becomes irrational or inadequate, the flex would still allow those rates to go down by the competitive pressure rather than having to wait for an insurance commissioner to have to approve a 5 or 8 or 10 percent rate decrease. Just like we should not be approving a 2 or a 3 percent rate increase because let the competitive market deal with that issue. That is not going to be material to the financial condition of that company.

Mr. DAVIS OF KENTUCKY. Okay. Thank you.

Chairman BAKER. The gentleman—oh, I am sorry.

Ms. KOKEN. Well, I would just comment very briefly that certainly there can be rate creep that does occur in a flex band situation that may not benefit the consumer and I will not go into that, but the other point I would make is that of course there are certain lines where there is very little competition within the State where it is critical to have a greater level of oversight, for example, in a number of States medical malpractice insurance is one where there is very little competition, and in some States there is very little competition in the health insurance arena also.

And so, certainly, I think that an across-the-board approach is not one that is going to balance the interests of the consumers versus the industry, and you need to look more closely.

Mr. DAVIS OF KENTUCKY. Thank you.

I yield back my time, Mr. Chairman.

Chairman BAKER. Thanks.

Ms. Wasserman Schultz?

Ms. WASSERMAN SCHULTZ. Thank you, Mr. Chairman, and let me just tell you that I now live for the day that I am a couple of rows back from here and understand why. And since my assignment to the Judiciary Committee, I have an even greater appreciation for our ability to work in a bipartisan spirit here. So I appreciate it very much.

Let me just comment that I think, not across all lines necessarily, but definitely in some lines, particularly life insurance, that we should consider that it might make sense to have some Federal aspect of regulation, not necessarily a national charter but with some good consumer protection, I think we could go in that direction.

Mr. Pickens, you talked about potential insolvency and the politics of underwriting. We have experienced that in Florida, no question about it. After Hurricane Andrew, we had seven insurance companies, I think it was at least seven insurance companies, that went insolvent because of the politics of underwriting and the politics of the competition of underwriting.

Insurance companies were low-balling rates, were significantly undercharging for property and casualty insurance, way undercharging, and as a result, after Hurricane Andrew, a 100-year storm, almost a lifetime storm, 7 of those companies went under.

And today, in 2005, our consumers are still struggling. We still do not have a fully restored P&C market in Florida especially after last year when we got hit by four hurricanes in 6 weeks.

The gentlelady from New York made a reference to her frustration with TRIA and how long is it going to go on and you need another 3 years. Let me tell you, I can feel her pain, because I have been feeling it for 15 years. We all have in Florida. There is certainly more certainty in the fact that we both know that we will get hit by a hurricane somewhere in this country as compared to a terrorist act and where we will get hit by a hurricane. We have a much more narrow region and more predictability.

So with that in mind, how would States make the necessary adjustments with Federal regulation because the SMART Act includes property and casualty insurance. With Federal regulation, how would a State like mine make the adjustments that they need to make based on our unique needs?

And secondly, we have struggled with the insurance of first resort, the insurance of last resort, we have multiple JUA's, joint underwriting associations, that although by law in Florida they have to be the insurance of last resort, essentially when there is no market they become the insurance of only resort. And that really is extremely problematic.

So while we are talking about that, what has not been raised here is the issue of a national catastrophe fund, and while we are talking about Federal regulations, I think it would be important to reinsert that issue into the dialogue, because I think it is necessary. Every State in this country, every region in this country suffers from some type of Federal disaster. So I would like to hear your comments on that, all of you, actually, before my time expires.

Ms. KOKEN. I guess I would just mention that is an issue that the NAIC and the commissioners are very concerned about. In fact, we have a working group that the Florida commissioner is very active on looking at just that issue on how we could create a mechanism for major catastrophes.

Ms. WASSERMAN SCHULTZ. If you can comment on what you see as the obstacle in Congress to a national catastrophe fund, because I know that it has been discussed before and sort of fallen by the wayside and is adrift at this point.

Mr. SERIO. Money is probably the biggest problem, the concern being that, and I think Mike Pickens mentioned it in his testimony, there have been these discussions about catastrophe reserving or catastrophe fund, the concern being, if you go back to TRIA 1 and the discussion there, there was real concern about bottling up a lot of capital, and what would become non-working or non-performing capital, in a fund like the British Pool Re has for their terrorism.

How do you make this thing work without really hamstringing that capital, and catastrophe reserving is one way you can do that. Because what it does, it really keeps the capital in the insurance companies and working for them but allowing them to accumulate

the kind of capital that they need to deal with a Florida situation or some other kind of a natural disaster, anything.

Another way to do that, and, again, everybody thought that maybe the securities markets and the swaps market would come up with a workable program for doing swaps on catastrophes, that in New York, it is terrorism; Florida, it is coastal and the hurricane; in California, it is earthquakes. Can we really do this? That has not really developed the way people had hoped it would. We really had a vibrant marketplace for these things, because at the end of the day the smart money knows that they cannot really control the weather, and they cannot control a spate of earthquakes or four hurricanes, which never happened before.

So I think there is going to have to be some new thinking in this before anybody can say, "Yes, this is the right way to do it." Because the sharing of that risk has been hard to do in that way. Individual State funds always get overwhelmed on that 1 year in 100 years. And so the reserving issue may still well be the best way to do it. That is how New York got through 9/11 by having essentially a reserve account on hand.

And maybe catastrophe reserving and promoting that among the insurance companies is the best way to actually get at that issue. So wherever it is that they are writing and whatever risks they are facing they have that money put aside to deal with those one in 50-year events. And then you figure out a way, how do you get that money back out when you find out that that event has not occurred?

Chairman BAKER. Mr. Pickens, did you want to jump in?

Mr. PICKENS. Mr. Chairman, just very quickly, you asked what would be in something like SMART for Florida, and I would draw a distinction between Federal regulation and what I see as the ultimate goal of the SMART bill.

To me the ultimate goal of the SMART bill is to preserve State regulation, not to create a Federal regulator. What I see would be in the SMART legislation or something positive for a State like Florida would be the flex band rating, would be the fact that it would be easier in Florida for insurers to get rate when they needed to get rate, and moving toward a competitive marketplace, I think, would be a benefit to the State.

Florida, as all of us know, has a tough rating environment. It can become highly politicized, as you read about in the newspapers. So I think that could be the best thing for Florida. And for a Florida regulator, it seems like to me something like a flex band rating would take a lot of heat off of the regulator if your law would allow for more flexibility in rates without the regulator having to be involved.

Chairman BAKER. The gentlelady's time has expired.

Mr. Bachus?

Mr. BACHUS. I thank the chairman.

First, I would like to say, welcome, Walter Bell, who is the Alabama insurance commissioner, who is serving as chairman of NAIC's Speed to Market Task Force.

And I guess my first question would be on that, and I will ask Ms. Koken—did I pronounce that right?

Ms. KOKEN. Yes, Koken.

Mr. BACHUS. Okay. I know that this compact goes into effect when you get either 40 percent of the States or the premium or either 26 States. How soon do you think that will come about?

Ms. KOKEN. Well, given the significant progress we have been making with 9 States in 2004 and at least 8 States this year and we think there will still be more, we really think that we are on track to have the 26 States or 40 percent of the market by the end of next year.

Mr. BACHUS. Okay. End of 2006?

Ms. KOKEN. Yes.

Mr. BACHUS. Okay. Let me ask the entire panel this: Do you think that State regulation of insurance has served the consumer or protected consumers? Do you think it has done a good job?

Mr. MUHL. My personal opinion, if I may, is that I think State regulation has been very sensitive to the needs of consumers, particularly in certain geographic areas. It is closer to some of the unique issues that come up, and I think the consumer, as well as a lot of the industry, has benefited from State regulation. So I am a believer that it is the better of regulation.

Mr. BACHUS. Is there anybody that disagrees?

I will say this: When you have price controls, I think they can impact consumers negatively. When you have high administrative costs on getting products out, that is a negative impact on the consumer. When you run up the administrative costs on licensing or delaying products in getting to the market, I think those negatively impact consumers.

But I guess my question is on what we more traditionally call consumer protection, you know, fraudulent products, misrepresentation. And I have not really heard any debate and I do not know about other Members of Congress but I have not heard anyone offer and argue that the State system is not protecting consumers. I do hear that it is unnecessarily driving up the cost because of these delays and having to deal with 50 different States.

I will ask Insurance Commissioner Koken, I think in your testimony you said that normally 8 to 10 years is reasonable for putting these reforms in place; is that right?

Ms. KOKEN. The statistics show that I think it is around there for implementing a compact, an interstate compact is what I was comparing. We believe that there continue to be a lot of important initiatives underway for modernizing, but it is an evolving marketplace, and that is not going to stop. But I would support the belief that the State regulators are very involved in addressing the concerns of the consumers on a local level.

I know in your State Commissioner Bell was very active in assisting the flood victims and was there immediately to help address their concerns. So we do believe that there are substantial numbers of questions that are dealt with by State insurance commissioners. They live in the communities, they have a sense.

Mr. BACHUS. I guess what I am saying, there has been some talk about 4 to 5 years is appropriate time, but I do know that in prior times when we have dictated to Congress certain actions be taken, I think 8 to 10 years is more a norm than 3 to 4 years. Does anybody disagree with that or agree?

Are you saying 8 to 10 years is a reasonable amount of time?

Now, would you say that we started in 1999 or 2003 for most of these things that we are asking you to come into compliance with?

Mr. PICKENS. Mr. Bachus, I would say that 8 to 10 years is an awfully long period of time, to be honest with you. What the appropriate period of time is I am not sure, but I know that when you look at things like the NARAB provision in Gramm-Leach-Bliley, insurance regulators were able to accomplish that within a 3-year period, well within a 3-year period, accreditation. And Mr. Pomeroy was around for that battle and certainly one that I am glad I missed. But when Mr. Dingell and Congress put heat on State regulators, they did what they needed to do in short order.

So I do not know that this body would be willing to wait 8 to 10 more years based of some of the things that I have heard and read. What the period of time is I think is something that is the subject for debate.

Mr. BACHUS. Could I ask one more question?

Chairman BAKER. Sure.

Mr. BACHUS. And you call can respond very quickly.

I noticed, Mr. Pickens, you have I think endorsed the SMART Act; is that right?

Mr. PICKENS. No, sir. I have not endorsed the SMART Act, per se. What I have said is that I believe, and I said it in my testimony, that when considered against the optional Federal charter or enacting a State-by-State approach over a period of time, SMART certainly could be a useful tool to State regulators to help them expedite the reforms that we have already agreed to and committed to this body that we would enact.

Mr. BACHUS. I am going to just ask that each of the members— Commissioner Koken has outlined, I think, starting on page 12 or 13 of her testimony what she thinks is wrong with SMART. I would ask the rest of you all to read that testimony and give me a one- or two-page response to whether you agree or disagree and what parts you would agree or disagree with what she said. Because I think that is at least a valuable piece of testimony and a good starting point in considering this legislation.

Thank you.

Chairman BAKER. I thank the gentleman. The gentleman's time has expired.

I would ask unanimous consent for the gentleman, Mr. Pomeroy, to be recognized and seated as a member of the subcommittee for the purposes of the hearing today. As a distinguished former commissioner himself, he fits right in with the panel.

Welcome, sir.

Mr. POMEROY. Thank you very much, Mr. Chairman, and I very much appreciate the ongoing diligent work you have brought to the somewhat obscure but highly important issue of insurance regulation. Clearly, everyone who has watched you work, whether or not we are necessarily agreeing with where you are going, understands the sincerity of the effort you put behind it. It really is to be commended.

Unique to hearings, I did not really care what the panel said, it was just a pleasure to be in their company again. I consider myself personal friends with each of them and would like to note for the record that each has made a significant personal effort to improve

the function of the insurance marketplace, always to the benefit of the consumer. And I was very impressed with your public sector work, and for those of you no longer in the public sector, I am impressed with your private sector.

Ed Muhl is somewhat unique having served as a regulator, then he went on to a distinguished performance in the private sector, came back as a regulator again. They called him Retread Ed in Albany.

I am also pleased, Mr. Chairman, that this panel was able to capture the dynamic of the discussion of those presently regulating and those who now have different perspectives perhaps because they no longer are regulators. I think that this is a useful dynamic.

While up at the NAIC meeting last weekend, I mean, we are all friends, we are all trying to in the end advance the same aims, we just have different perspectives and those will vary over time depending on how you look at things. But this has been a good panel, I think, having this mix.

I would have a couple of points of observation relative to earlier comments that have been made, as to the terrorist coverage afforded by TRIA. I think that we are not at a point in time where we want to walk away from that. I think that TRIA ought to be extended. I think it has worked. And, essentially, if you are going to have private capacity to entirely handle the still infant, undefined and somewhat infinite risk of terrorist exposure, you are going to have to have higher rates and extraordinary reserves established.

I think that dealing with this as a contingent funding mechanism, as TRIA has done, has really gotten us tremendous capacity without much up-front dollars. And that has saved the American people a lot of money. And so I hope that we can continue with the TRIA approach, at least for the immediate future.

As to the SMART legislation, and I have been interested in this discussion, I think that—let's throw our cards on the table—the most controversial part of the bill is the property casualty rate preemption piece of it. And if the chairman wants that included, he is to be commended for his courage, I suppose, but it has made passing the bill, in my opinion, much less likely.

So let's go across the panel and I would ask you whether you think that the property casualty State rate approval preemption whether that is a critical part of the legislation, as you see it.

Let's start with Mr. Pickens and just run right on down the panel.

Mr. PICKENS. Mr. Pomeroy, first of all, thank you for your comments, and I certainly second all of those right back at you. You have been a good friend and appreciate your advice over the years.

I do believe it is important to include some rate provisions in the SMART legislation. And the reason is because I think that in a competitive market, in a competitive market, not in a noncompetitive market, but in a competitive market, the best regulator of rates is the marketplace.

And I believe the regulators should always have the authority in a competitive to determine when rates are excessive, inadequate or unfairly discriminatory, but for prior approval of rates I think the time has come and gone for prior approval of rates. And I think if

you look at the States where prior approval exists or has existed, even though it may not be the only reason that there are problems in those markets, it certainly is a primary reason.

And, again, I think something like flex band rating is a good transition to a competitive rating scenario, but I would always like to see the regulator be able to determine that rates are inadequate, excessive or unfairly discriminatory on the back end. I think regulators always need that ability.

Mr. SERIO. I think the SMART dialogue has brought us a long way on the rate issue. Yes, it is crucial as far as an issue, and it has been an issue of particular importance to me, but I think where the dialogue has gone, the dialogue has gone from where it was just a competitive rating, moved just to competitive ratings, and now talking about a transitional period and understanding the value of flex rating, I think that that kind of a construct can work.

So long as there is enough backsize authority for the regulators to make sure there is enough financial support for the rates that are being charged, I think that the rating issue can be resolved amicably for everybody involved in the SMART bill.

Mr. COVINGTON. Thank you, Congressman Pomeroy, and thank you for your kind comments. I too think that the rate issue is a critical issue to be included in the legislation. It works, it has been proven to work. It works in Ohio, it works in Illinois. I have not been given any evidence that it does not work in some place, other than with maybe respect to coastal type issues.

And right now it diverts scarce resources that should be spent on other priority regulatory issues and really distorts the marketplace. That is what really all the studies show.

So I do think that the rate issue should be included in SMART.

Mr. SHAPO. My answer is, yes. We were talking about it the other day. I did not get to finish my hard sell on you. I had to leave to go see a client, if I remember correctly.

Yes, I think it should not only be included, I think it should be the first issue that is dealt with, not the last. It should not be the first one jettisoned, it should be the first one dealt with. And that is because it is the biggest impediment to interstate commerce in the regulatory system. It is the most mismatched aspect of the regulatory regime, harmful to consumers, it hurts supply, diverts scarce resources, and it is very much Congress' business. This a result of past congressional action. Congress made a policy choice 6 years ago to disable competition to enable collusion. So it could not be more Congress' business.

And if the goal of the SMART Act is to protect the fundamental primacy of the States in regulation and if the goal is to try to come up with a workable system and to stave off a Federal charter, again, I think this is the first issue that should be included, not the first issue that should be jettisoned. Because it unfortunately needlessly antagonizes natural allies of State regulation: The property casualty industry.

Property casualty carriers definitely do need to be attuned to local markets and have traditionally been, not all of them, but generally have been strong supporters of State regulation, and that is changing now. There is—

Mr. POMEROY. The chairman is being very lenient on time, so you will have to move this along.

So I hear we have to preempt the States to protect their primacy.

Mr. SHAPO. Yes, and it is particularly apt on this issue, because the States are doing what they are doing because Congress incentivized them to do it. It was explicit congressional policy to try to get the States to pass prior approval rate regulation across the board.

Ms. KOKEN. I would say that all of the members of this panel have all been commissioners, and all support the importance of streamlining rate regulation. However, we believe that how that is done and the balancing for the benefit of the consumer and balancing that against the needs of the insurers should be done by the States. So we would not support preemption of rates.

Mr. MUHL. Mr. Pomeroy, it is good to see old friends and colleagues. Life and time has treated you well.

An answer and a response to what you had asked, I believe a less restrictive rate regulation is a key element to making the process less costly ultimately for the consumer and creating a very competitive process that the companies can function in. I think everybody benefits. So I think it is very much a key in the SMART draft to have that as a key piece of the legislation.

Mr. POMEROY. I would just, in closing, Mr. Chairman, indicate that I believe, just talking about politics, there is some considerable feeling here, probably on both sides of the aisle, that this might be a judgment best left to the States and they will find their own way based upon what works for their marketplace. And if there would need to be a Federal preemption of that State decision-making, I think there would need to be a demonstration beyond inefficiency for insurance companies and inefficient functioning of the marketplace, really more of a demonstration of severe market dislocation of an irreparable dimension that required this type of action.

But it is early and who knows, there has been a lot of things passed around here that I would have never guessed would have made it. So I think this dialogue and the chairman's substantive dealing with this topic are certainly key strategies to advancing the ball here.

Thank you very much.

Chairman BAKER. I thank the gentleman for his contribution, and my assurance is we are not going to surprise anybody. It will not be a sneak attack.

Ms. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman.

You probably all thought you were just about finished till I walked in, so I will not take very long. I just wanted to ask one quick question of my friend from Illinois, the former insurance commissioner, Mr. Shapo. I would be remiss if I did not.

My question is, don't government price controls on insurance reduce consumer options and make insurance less available, and then it would drive more consumers into the secondary residual markets? More States have such markets.

Mr. SHAPO. Representative, thank you. It is very good to see you. Thank you for all your past kindnesses.

The answer is, yes, price controls will not reduce prices but they will reduce supply. They will reduce availability. Affordability and availability end up running into each other, and attempts to increase affordability fail for themselves but then they end up hurting availability.

In Illinois, where market forces are used to regulate prices, as they are throughout the economy, the assigned risk plans are infinitesimal, far less than 1 percent of insureds in the State.

Mrs. BIGGERT. Yes. We seem to have the Illinois model where we really have a lot of competition.

Mr. SHAPO. Yes, ma'am. And it has a 30-year track record. And it is not to be seen as an experiment, I don't think, or kind of a unique outlier that somehow manages to work. I mean, it would be bizarre if it did not work. This is the way commerce is regulated throughout the economy, and if not for strange historical circumstances which do not exist anymore, there would be no talk about regulating insurance rates.

Mrs. BIGGERT. Thank you.

Thank you, Mr. Chairman. I yield back.

Chairman BAKER. I thank the gentlelady.

I feel I need to make at least sort of a summary statement as to the public expressions I have made on the subject of the necessity for a proposal seeking some sort of uniformity that is clearly not there today and the probability that at least I will propose, subject to Chairman Oxley's consent, some action by the committee in the course of the remaining legislative time.

There have been numerous hearings and meetings. We even had things called roundtables. Everybody just come in and sit down and talk. I mean, I wake up and think about insurance, and if that is not a distressing thought.

At least you got Fannie Mae off my mind. Maybe that is the improvement.

The point, though, in trying to be objective and understanding, this is a very convoluted process to alter with State legislatures and governors and commissioners and companies and agents involved in all of this, it is not easy to point to a particular direction and say, "Let's go there and get this fixed."

But let me just run through some things to put it on the record. Ms. Koken, I am not citing you as the current NAIC Chair as responsible for any. This is an ongoing discourse with the NAIC and the general NCOIL, everybody, to try to how do we get where we believe we need to go?

The Health Carrier Prescription Drug Benefit Management Model Act, zero States; Health Carrier Claim Audit Guidelines Model Act, one State; Individual Health Insurance Portability Model Act, one State; Model Regulation to Implement Individual Health Insurance Portability Model Act, one State; Health Information Privacy Model Act, zero States; Health Care Professional Credentialing Verification Model Act, one State; Quality Assessment and Improvement Model Act, two States. This is boring.

It is numerous numbers of model acts which have less than 10 States who have, as of the date of preparation, January 2005, have moved. These items have not been on the public docket for a matter of weeks, months, literally years, in some cases for more than

a decade. We have had commissioners repetitively saying, “You know, about 3 years is what we need.” And I think I heard a 3-year statement today.

The 3 years clock has worn out. We have wound it too many times. We are going to have to take some action.

Now, why do I think this is so vitally important? When you look at the fees and assessments made by States through the regulatory process on companies and you look at the disposition of those revenues in relation to consumer protections, about 8 percent of the fees collected go to regulatory purposes.

Now, if I had to ascribe any single thing that affected the cost of providing insurance to consumers at a more competitive price, I would start looking at State governments’ role. And, believe me, coming from Louisiana with our history in insurance regulation, I am an expert on that kind of stuff.

You know, who is looking at that rate review process and determining whether or not the fees and assessments are really adequate and necessary for consumer adequacy?

Then you look to the NAIC itself, it is an unusual organization in that the bulk of members or majority are appointed, they do not have enforcement authority, they cannot go to the legislature and say, “Do this or else.” In fact, given the history of the model act considerations, there is no downside consequence to a legislature ignoring a well-intentioned commissioner from following their studied recommendation.

But then to make it even more specific, today, in your outlining of goals and assessing the progress made and identifying things you think are moving in the right direction, the statement was made that uniformity is not the goal. Well, that is a deep policy difference that we have. Uniformity is the goal.

Secondly, with regard to price preemption, I know that is volatile. I know that members have extreme concerns, but I also understood you to say that flex band has some concerns for you and that the current prior review process may be the way to stay.

This all leads me to conclude that we need to have a centrist bill boiled down to the core principles we started with 2 years ago, put before the committee and let members make a decision whether or not adopting a proposal that provides the standards established by the SMART Act with some sort of price relief, subject to the protections that those who have raised issues in the hearing today are guaranteed those protections are in place, centered around the real-life practical experience of those States who have moved generally in that direction. Louisiana has a flex band. I mean if we can do it, anybody can do it.

And so I think that there is ample opportunity for us to work. I am making this long diatribe simply to announce that going forward the NAIC and everybody should have, who have interest, a copy of the draft. We want to hear comments and assuming Chairman Oxley gives his consent and I get a committee slot to do it, we are going to come back and put a proposal on the floor. So start those cards and letters to your congressmen.

Get everybody ginned up, we are coming, and I hope this is not a surprise to anybody, but I also hope that you understand that this, as some have indicated on the Democrat side, that this is

driven by deep-held policy convictions, not for any particular interest other than to have a market that functions and provides consumers with products at a reasonable price.

And I certainly do not wish to put you in any untenable position, Ms. Koken, but it would be rude of me not to offer you the chance to make any comment that you would choose to make if you choose to.

Ms. KOKEN. Well, I thank you for that and would also thank you for the opportunity to appear here today and to be engaged in this dialogue, because we do recognize the importance of it.

I think that I would only want to clarify that I was not suggesting that the State insurance regulators are in support of a prior approval system. Certainly, in many States, they have gone to a flex band but in many other States they have gone to file and use. And I am not here to say that flex band or file and use or use and file is preferable under any circumstance but to say that the balancing that occurs to determine what is best for the consumer. So that we think is a State issue.

But, certainly, we appreciate that it is critical that there be greater uniformity that occurs in the marketplace, and our compact and SERF initiatives and NAPR and the whole list are evidence of that. We recognize that in some situations the goal is not for absolute uniformity, uniformity of process, but, certainly, throughout the whole process our goal is to balance the business efficiency with the interests of the consumer, and I certainly appreciate that that is also your goal and that we share the same common vision of trying to get to a better solution, and we continue to want to be engaged, as you revise and come out perhaps with a new draft of the bill.

Chairman BAKER. I thank you for your courtesy.

Mr. Scott, did you have any further comments?

Mr. SCOTT. Very briefly, Mr. Chairman. I just want to again extend my bipartisanship support to you and again to commend you for your consideration of the concerns that have been raised on the Democratic side, particularly in the area of preemption, in the area of consumer protections and the points that I raised, of course, on the discrimination to make sure that we have a strong bill going forward that has the utmost end consumer protections.

But, again, I commend you for agreeing to hear those concerns and to move forward with the bill, and I look forward to working with you as we iron these things out.

Chairman BAKER. I thank the gentleman for his kind statement.

If there is no further statement by members, I duly appreciate each of your participation here today. It has been I think a constructive and very helpful meeting.

Our meeting stands adjourned.

[Whereupon, at 1:12 p.m., the subcommittee was adjourned.]

A P P E N D I X

June 16, 2005

STATEMENT OF THE HONORABLE SUE KELLY
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
June 16, 2005

Thank you Chairman Baker for holding this important hearing.

The McCarran-Ferguson Act enshrined the principle of state regulation of our national insurance market. State regulation of insurance ensured that customers receive the best protection quickly, and that developers of insurance products were meeting the needs of all consumers in the market.

In the 60 years since McCarran-Ferguson was passed financial markets have changed immensely, and competition within the insurance industry and between insurers, banks and securities firms has become fierce. While national and international standards exist or are emerging, insurance largely retains the same regulatory patterns.

Several years ago this committee took the lead in passing NARAB, to encourage states to adopt uniform licensing standards or face a National Association of Retail Agents and Brokers. This measure has worked to bring the states together, but has not eliminated duplicative regulation.

I support states rights, and oppose federal preemption for preemptions sake. Consumers, however, are the ones harmed by the inability of the insurance industry to compete nationwide on financial products. The sick and elderly need access to new products that recognize changes in medicine and retirement savings. Homeowners and small businesses need new products to match their growth in equity and opportunity. I urge the current and former commissioners present to work with each other, the industry, and this committee to develop an insurance market for the 21st century.

The SMART Act is only the second most important insurance issue facing this committee. TRIA, the Terrorism Risk Insurance Act, expires

at the end of this year. Millions of policy holders around the country are already being notified that terrorism insurance will not be available for them next year if this Congress does not act. Our economy cannot afford to be slowed down by the fear of loss from terrorism. While some have said that the private market for terrorism insurance is robust, no less an authority than Chairman Alan Greenspan has told his committee that without government assistance there cannot be a functioning market for terrorism insurance.

I am pleased to see New York's former Insurance Commissioner, Greg Serio here, who has been a tireless advocate for TRIA and for insurance consumers in New York and nationwide. I look forward to hearing from him and all of our witnesses today.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON INSURANCE REGULATORY REFORM

THUSDAY, JUNE 16, 2005

Mr. Chairman, we return this morning to a topic that we have often discussed in recent years: the need for insurance regulatory reform.

No matter what side one takes in this long-standing debate on regulatory efficiency, it has become clear to me that this is no longer a question of whether we should reform insurance regulation in the United States. Instead, it has become a question of how we should reform insurance regulation.

As you know, Mr. Chairman, we have begun to develop a growing consensus in the Congress about the need to improve insurance regulation. In an attempt to advance these efforts, you have also crafted a lengthy and complex outline for achieving regulatory reform in the insurance industry. This evolving proposal has, at best, received lukewarm support from the many parties to which I have spoken about the draft reform plan.

Many participants in the insurance community have also expressed strong reservations and deep concerns about this plan. For example, the North Dakota legislature has passed a resolution indicating that the proposal would "impair, erode, and limit the ability of state governments to regulate the business of insurance." A committee in the Ohio assembly has also urged us to oppose the plan.

The National Association of Realtors has additionally expressed its opposition to efforts to impose "a system of mandatory, uniform national standards for personal and commercial property insurance." Moreover, consumer groups have determined that the "sweeping proposal would override important state consumer protection laws, sanction anticompetitive practices by insurance companies and incite state regulators…to further weaken insurance oversight."

After expending considerable time and effort studying these matters, Mr. Chairman, the National Association of Insurance Commissioners has raised its own concerns about your proposal to reform insurance regulation. I am therefore very pleased that we will have before us today the leader of this venerable organization. Diane Koken is a savvy and competent overseer of Pennsylvania's insurance markets. Because she has also served under Republican and Democratic governors, she can offer us a bipartisan perspective on insurance regulatory reform.

During our previous hearings on insurance reform, we have received extensive testimony from many witnesses advocating the creation of an optional federal charter. Mr. Chairman, although your evolving plan still does not address this important issue, the consensus for creating such a charter continues to grow. Rather than overlaying a federal bureaucracy on top of state regulation, an optional federal charter would, in my view, create a sensible, separate, and streamlined regulatory system.

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Such dual oversight has worked generally well for the banking industry for many decades, and we should now consider applying it to the insurance industry as well. Moreover, because of its standardized products and nationwide marketplace, the life insurance industry, from my perspective, is particularly ready for the adoption of an optional federal charter.

While the issue of insurance regulatory reform is an important one, I am very disappointed that we are meeting on a bill that has yet to be introduced and for which there is no pressing need, before resolving the critical issue of extending the Terrorism Risk Insurance Act. After tomorrow, we will have just nine weeks remaining on the official legislative calendar for the session. The federal backstop to provide economic stability for America's workers and businesses, however, will expire at the end of the year.

We therefore need to move expeditiously on the matters of greatest importance. We need to approve in the Financial Services Committee legislation to extend this important program. We need to write a report. We then need to pass the bill on the House floor. We also may need to work to resolve any differences with the Senate's version of legislation to extend the program. The time is short, and we need to act now to extend the Terrorism Risk Insurance Act.

In closing, Mr. Chairman, I commend you for continuing to focus our committee on the issue of insurance regulation. I, however, also hope that we will henceforth get our priorities in order and resolve the issue of extending the Terrorism Risk Insurance Act as quickly as possible. These are important discussions for us to have and important matters for us to resolve.

Testimony of J. Lee Covington II

Before the United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises

Thursday, June 16, 2005

Testimony of J. Lee Covington II

Before the United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises

Thursday, June 16, 2005

Chairman Oxley, Chairman Baker, Ranking Member and Members of the Committee:

Thank you for the invitation to testify before your Committee today on the important issue of insurance regulatory reform. I express my deep appreciation for your past courtesies to me during my service as Ohio Insurance Director and the outstanding support and working relationship I had with you and your tremendous staff. We worked very successfully on Gramm-Leach-Bliley, the Financial Services Fraud Network Act of 2001, the Terrorism Risk Insurance Act, and other important legislation. It is very good to be with you again.

I am testifying today in my capacity as the former Director of the Ohio Department of Insurance and my views do not necessarily represent those of PricewaterhouseCoopers or our clients. I am not a Certified Public Accountant (CPA) and my testimony will not address any matters related to the standards governing CPAs as adopted by the American Institute of Certified Public Accountants (AICPA) or the Public Company Accounting Oversight Board (PCAOB). I will not be not advocating client positions or PricewaterhouseCoopers' positions during my testimony.

I have had the pleasure of working with the Committee during the development of SMART providing high level policy and structural insights and technical assistance on specific issues addressed in SMART. I appreciate the opportunity work with you and my former colleagues to ensure insurance consumers have necessary regulatory protections, consumer choice, and competitive markets inuring to their benefit, as well as assuring a

reasonable regulatory environment for companies and agents delivering vital insurance products and services to policyholders.

As you know, the National Association of Insurance Commissioners (NAIC) began a renewed and very close working relationship with the Committee after passage of Gramm Leach Bliley ("GLB"), beginning in early 2000, with the NAIC's adoption of its Statement of Intent—The Future of Insurance Regulation. During the past 5 years, NAIC, National Council of Insurance Legislators (NCOIL) and National Conference of State Legislators (NCSL) have all had great leadership, from the very top of the organizations to the individual members working on the numerous initiatives making up the overall reform plan. My good friend, Commissioner Diane Koken, NAIC President, has not only led individual initiatives, but also has provided strong leadership this year after stepping directly into the Office of President for the NAIC in December 2004. Each organization has had an unprecedented level of commitment, focus, work, and energy throughout this time period. I know this because I was heavily involved in many of the initiatives, I know how much time I was devoting to the work and I know how much time and staff others have been devoting to these efforts. The current and past efforts of these organizations are really remarkable.

Significant progress has been made on a number of the initiatives contained in the original Statement of Intent, including developing and operationalizing the National Insurance Producer Registry (NIPR), as required by the NARAB provisions of GLB; enhancing and deploying SERFF, now used in 51 jurisdictions, with 41 and 44 states, respectively, now accepting all major lines of business for life and property and casualty products, and an average review time of 30 days for 72% of filings; and adopting the Interstate Compact Model Law in December 2002. I am sure other witnesses will identify additional areas of important progress.

For very understandable reasons, other initiatives have been slower in development and implementation, and the effectiveness of some initiatives as currently operationalized remains unclear. For example:

- While addressed in the Statement of Intent in 2000, recognizing Market Conduct is one of the most difficult issues for which to develop legislation, the NAIC/NCOIL Market Conduct Surveillance Model Law was approved 4 years later in September 2004. To my knowledge, only one state has adopted any version of the Model.

- The Property and Casualty Commercial Rates and Policy Form Model Law, adopted in 2002, which incorporates a competitive rating system for commercial lines insurance based on actuarially sound principles, has not been adopted or introduced in any state, for many if not all of the reasons outlined in Former Commissioner Nat Shapo's written testimony.

- The NAIC has developed several market conduct operational initiatives aimed at allocating regulatory resources to key regulatory issues, using market analysis techniques and tools to identify companies having a greater likelihood of regulatory non-compliance, and coordinating regulatory examinations to efficiently use resources, eliminate examination duplicity and minimize undue burden on companies. These include the Market Conduct Annual Statement, the Market Conduct Analysis Handbook, Uniform Examination Guidelines, and Standardized Data Calls. While these have been implemented by some states and show much promise, the number of states adopting these initiatives and the impact of these initiatives remains unclear with respect to achieving the goal of an efficient and effective national state-based market conduct surveillance process.

After all the efforts to institute regulatory reforms over the past 5 years, regulators, legislators and other stakeholders widely recognize the challenges and obstacles to achieving reform, which include:

- Collective Action Issue:
  The NAIC consists of more than 50 state Insurance Commissioners and their staff working through over 100 committees and working groups. The development of model state laws and initiatives through its consensus process takes substantial time, something all of your members have experienced in Congress. Once the NAIC and/or NCOIL adopt a model law, then it must be adopted by individual states legislatures which have their own diverse priorities, interests and time frames. In the end, the NAIC has no authority to pass its Model Laws and the challenge of seeking adoption by individual state legislatures is substantial, even with the strong support and work of NCOIL and NCSL.

- Lack of industry effort to move certain bills, which may stem from numerous possibilities, such as known priorities of individual state legislatures, known positions of individual state legislatures, or lack of support for a particular model.

- Continued proliferation of unwritten rules, known by most as "desk drawer" rules and lack of execution according to the intent of a particular model law or reform initiative.

Based on the Ohio experience, even with these barriers, necessary reforms can be implemented. Ohio has done it. With respect to Speed to Market, during my tenure, we implemented SERFF in 2000, in approximately 30 days, and today, over 40% of all filings are submitted via SERFF with an average review time of 15-20 days. Ohio was the first state to implement a reciprocal agent licensing system incorporating NIPR where agents could be electronically fingerprinted, tested and licensed within 5 days and simultaneously licensed in all NIPR states. Ohio was one of the first states, if not the first, to use market analysis data calls to focus resources on companies having the

greatest likelihood of regulatory non-compliance with respect to key regulatory requirements. Regarding financial surveillance, Ohio was the first state to develop and use a CARRMELS prioritization system, similar to the ratings used by federal banking regulators and now used by the NAIC; Ohio was the first to implement a risk focused approach to financial examinations, long used by federal banking regulators; and Ohio was the first to coordinate the examination of companies within an insurance holding company structure. Ohio was also one of the pilot states for CARFRA.

While no new measures were implemented with respect to rate filings, Ohio has long embraced a competitive rating system based on sound actuarial principles, and as a result, Ohio citizens consistently enjoy homeowners rates ranking from the 2nd to 5th best in the country and automobile rates ranking between 14th and 17th best in the country.

With regard to the current rate and form review process, Former Illinois Insurance Director Nat Shapo will be speaking in more depth about competitive rating, but some background may be helpful. In December 2000, the NAIC Speed to Market Working Group adopted a Report recommending a "no filing" system or "informational only" filings for most commercial lines rates and forms, with a limited number of products and rates to be subject to regulatory review or with a review required when the Commissioner makes a formal finding that a non-competitive market exists. In Spring 2002, based on this report, the NAIC adopted the Property and Casualty Commercial Rate and Policy Form Model Law. While a very limited number of states have enacted incremental reform, no state has enacted the NAIC Model.

With respect to personal lines rates and forms regulation, with the exception of independent reform efforts in New Jersey, South Carolina and Louisiana, the status quo for rate and form regulation remains intact. On this issue, unlike others, the NAIC has not been able to obtain consensus about moving to a more market-oriented system of regulation. When I left my position as Insurance Director in Ohio, little interest existed among regulators to even address the issue.

In Ohio, for homeowners insurance, consumers enjoy an average savings of $160-170 compared to the national yearly premium average of $535. For automobile insurance, they enjoy approximately $170 in average savings compared to the national yearly premium average of $775. These savings would be substantially more when compared to states with price control rate regulatory schemes. Competition works, and I am pleased, Mr. Chairman, that you and your Committee continue to pursue a competitive insurance marketplace that benefits consumers.

Most, if not all, insurance regulatory stakeholders agree reform is needed, and the debate is about how, by whom and under what timeframe reform should be accomplished. Commissioner Koken, in her usual eloquent and thoughtful opening address during the NAIC's Summer Meeting, reinforced that we all have the same goals and the discussion should be about process and procedures.

To this end, fair questions for this Committee to consider include:

- Whether the states will ever be able to overcome the collective action issue and adopt completely and uniformly the necessary model laws to achieve reform?
- How long will it take the states to complete this work?
- If the necessary model laws are actually adopted, will states ever be able to operationally coordinate their work, as intended, when executing their duties under those laws?

SMART provides the opportunity for States to maintain a state based regulatory system with needed reforms. While some may object to the preemption provisions, which should only be used as a last resort, the question exists as to what other options do policymakers have if the states cannot institute the agreed upon reform initiatives.

Mr. Chairman and Members of the Committee, thank you again for a very positive working relationship in the past. I look forward to continuing to work with you and my friends and former colleagues at the NAIC to assure SMART meets our common goals of

necessary consumer protection, consumer choice, and competitive markets that benefit consumers. I look forward to answering your questions.

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Mr. Covington, former Director of the Ohio Department of Insurance, is a member of the PricewaterhouseCoopers Insurance Regulatory and Compliance Solutions Practice where he advises companies on regulatory and compliance issues, as well as issues related to class action lawsuits and other insurance related lawsuits. He also provides consulting services to state insurance departments in connection with financial surveillance operations and , receiverships.

Mr. Covington, former Vice-Chair of the NAIC Market Conduct Committee, has substantial experience conducting regulatory consulting related to state market conduct examinations, including emerging multi-state collaborative action market conduct examinations conducted under the auspices of the NAIC Market Analysis Working Group (MAWG). Related to these efforts, he has been integrally involved in compliance assessment and remediation projects for companies subject to market conduct review. He also provides regulatory advisory services related to the full range of regulatory issues facing companies.

Mr. Covington has also led the legal and compliance component of the firm's Sarbanes Oxley preparatory work for major multi-national financial services company, including review of the processes relating to the following: Employee Code of Conduct; Code of Ethics for Financial Professionals, Complaint Process for Accounting and Auditing Matters; Whistleblower Protection Procedure; Personal Trading Policy; Conflict of Interest Disclosures; Board Oversight; Regulatory Filings; Legislative/Regulatory Risk Monitoring; Judicial Development Risk Monitoring; Marketing Materials; Regulatory Examinations; 10K and 10Q Disclosures; and Distribution Channel Risk (Agents, Illustrations, Replacements, Suitability, and Complaints).

Prior to joining PricewaterhouseCoopers, as Director of the Ohio Department of Insurance, Mr. Covington worked with Congress on the Gramm-Leach-Bliley Financial Services Modernization Act and was a member of the core team of regulators who drafted the National Association of Insurance Commissioners (NAIC) Statement of Intent for the Future of Insurance Regulation. Mr. Covington was also one of the principle drafters of the Interstate Insurance Product Compact Model bill. Mr. Covington served as Chair of the Regulatory Reengineering Committee and Improvements to State Based Systems Committee, which developed the Commercial Lines Rate and Form Modernization Bill and reengineered the System for Electronic Rate and Form Filing enabling the system to serve as a one stop national filing system.

While serving as Director, Covington testified before Congress three times on insurance modernization issues and other regulatory issues. He worked closely with Congress on the Federal Terrorism Insurance Bill and Financial Services Anti-Fraud Bill.

As Vice-Chair of the NAIC Market Conduct and Consumer Affairs Committee, Covington was a key leader in designing a system to streamline and coordinate market conduct examinations across the country. Covington was Chair of the E-Commerce Working Group and Statistical Information Task Force. He was also Vice Chair of the Accounting Practices

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and Procedures Task Force and Special Insurance Issues Committee, and served on 7 other major committees and numerous working groups.

Covington was recognized as a "Renaissance Regulator" by Best's Review and was a member of the NAIC Executive Committee, chairing the NAIC Midwestern Zone.

In Ohio, Covington was active on Class Action lawsuit issues, filing over 10 amicus briefs or intervention actions in Ohio and across the country where class actions intruded into the jurisdiction of state insurance regulators. In November 2002, Covington participated in the Financial Services Class Action Symposium sponsored by the Manhattan Institute and the Federalist Society. Covington also reorganized the Ohio Liquidation Office resulting in an unprecedented $260 million early access payment to creditors and policyholders and an aggressive plan to close liquidation estates inuring to the benefit of policyholders and creditors.

Even prior to Sarbanes-Oxley, Covington implemented a new risk assessment financial examination process focusing on corporate governance and risk management issues streamlining the process for well managed, financially sound companies and creating greater scrutiny for at-risk companies. Under Covington's leadership, the Department received some of the highest accreditation scores ever awarded by the NAIC.

Covington conducted the most comprehensive automated prompt payment market conduct examination ever performed. And, he worked to pass and implement the Governor's Patient Protection Bill, which has resulted in the payment of over $2 Million in previously unpaid health insurance claims.

Covington is a member of the Board of the Griffith Foundation for Insurance Education and he also served on the Governor's Joint Committee of the Governor's Council on E-Commerce and Interagency Information Management Group, which developed Ohio's e-government strategic plan. He is a former member of the board for the Journal of Insurance Regulation.

Career History:

2003 to date	PricewaterhouseCoopers Insurance Regulatory and Compliance Solutions Practice
1999-2002	Director, Ohio Department of Insurance
1997-1999	Deputy Commissioner, Arkansas Department of Insurance
1997	Legislative Liaison and Legal Team Member, Governor of Arkansas
1993-1997	Insurance Corporate and Regulatory Practice, Mitchell, Williams, Selig, Gates & Woodyard
1992-1993	Law Clerk, United States District Judge Jimm L. Hendren

Education:

1989	B.S.B.A, Finance and Banking, University of Arkansas
1992	J.D., University of Arkansas (Member, Arkansas Law Review)

Testimony of the
National Association of Insurance Commissioners

Before the
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises

Committee on Financial Services
United States House of Representatives

Regarding:
Impact of the SMART Act on State Insurance Regulation

June 16, 2005

Diane Koken
Commissioner of Insurance
Pennsylvania

Testimony of Diane Koken, President
National Association of Insurance Commissioners

Introduction

My name is Diane Koken. I am the Commissioner of Insurance for the Commonwealth of Pennsylvania, and this year I am also serving as President of the National Association of Insurance Commissioners (NAIC). I am pleased to be here on behalf of the NAIC and its members to provide the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises with the views of state insurance regulators. State insurance regulators are public servants representing the same people who are your Congressional constituents. We share your goal regarding the importance of regulation that balances the need for vigorous consumer protection with vigorous business competition to provide a healthy insurance marketplace for consumers.

Today, I would like to make three basic points –

- First, the NAIC is an organization of state government officials who are sworn to faithfully administer the laws enacted by our respective state legislatures and governors on behalf of our citizens. We are not a trade association. NAIC members recognize that protecting American consumers is our top priority and the reason for regulating insurers and producers. We are proud that responsive and effective consumer protection is the hallmark of state insurance regulation. As an organization of state officials, the NAIC has long been actively engaged in providing Congress and the federal government with technical expertise and policy guidance on insurance issues.

- Second, the states and the NAIC are on time and on target to modernize state regulation where improvements are needed, while preserving the benefits of consumer protection that is our real strength. In some areas, the goal is to achieve

national uniformity because it makes sense for both consumers and insurers. In areas where different standards among states reflect regional needs, we are harmonizing state regulatory procedures to ease compliance by insurers and agents doing business in those markets. In short, the state regulatory system has already recognized and is working to address legitimate modernization concerns. The states, more importantly, are committed to a continuing process of modernizing our nation's regulatory system as the marketplace continues to evolve, and to do so without sacrificing important consumer protections.

- Third, the draft SMART Act incorporates unacceptable levels of federal preemption that would create both legal and practical problems for the insurance industry and its customers. A thorough analysis of the SMART Act by 117 insurance regulatory experts from your home states identifies concerns where the bill would preempt many important state laws that protect consumers from unfair or discriminatory marketing, inadequate or excessive rates, and unsound products. Federal preemption of state insurance regulation denies your Congressional constituents the benefits of important state services and protections, as has already been proven in existing federal programs, such as FEMA in its administration of the National Flood Insurance Program, and ERISA through its taking away state authority to assist your constituents. The states believe it is constructive to point out basic constitutional, legal, and operational problems that would undermine the SMART Act's stated purposes.

Protecting Consumers is the First Priority of State Insurance Regulation

Paying for insurance products is one of the largest annual consumer expenditures of any kind for most Americans. Figures compiled by the NAIC show that an average family can easily spend a combined total of $4,500 each year for auto, home, life, and health insurance coverage. This substantial expenditure – often required by law or business practice – is typically much higher for families with several members, more than one car,

or additional property to insure. Consumers clearly have an enormous financial and emotional stake in making sure the promises made by insurance companies are kept.

Because they are typically complex and involve subjective decisions by insurers about policy coverage, rates, and paying claims, insurance products can generate a high level of customer dissatisfaction that requires a high level of regulatory responsiveness. When problems arise, state insurance departments are fully-staffed to handle consumer inquiries and complaints quickly with a local phone call. State regulatory staff are local residents who understand the contract and tort laws that govern insurance products in their state. As regulators of insurance, we are responsible for making sure the expectations of American consumers – including those who are elderly or low-income – are met regarding financial safety and fair treatment by insurance providers. The entire state-based system of insurance regulation and solvency guaranty funds is authorized, funded, and operated by the states, with no cost to the federal government.

As government officials responsible for operating the state system, we understand that any government regulation of business – including insurance – can be inconvenient and occasionally frustrating to commercial entities that wish to do business on their own terms. State regulators are constantly improving our standards and procedures to meet those concerns. Although some industry representatives complain about the state regulatory system being inefficient and burdensome, there is nothing in our experience to indicate that a single federal regulatory solution setting national standards could anticipate and handle insurance supervision as well as the state system had done.

The states believe that consumers are best served by knowledgeable insurance department employees who are accessible in the state to the consumer, and who understand the local issues impacting the insurance marketplace in their state. During 2003, state insurance departments handled approximately 3.4 million consumer inquiries and complaints regarding the content of their policies and their treatment by insurance companies and agents. This service to consumers is provided at little or no cost to them, and has resulted in the recovery of substantial consumer restitution.

NAIC and the states reject the notion that consumer protection is incompatible with a vibrant and competitive insurance industry. In fact, we know the opposite to be true. Effective consumer protection is integrally related to maintaining positive business climates in our states. The American insurance industry is the most successful in the world, with countries around the globe seeking to emulate our balanced regulatory environment in order to achieve the kind of consumer and investor confidence necessary to expand their insurance markets.

A few short years ago, there was much talk in the property and casualty industry about rate regulation being a major contributing cause to the industry's anemic financial results. Today, however, the property and casualty industry is sitting on record surpluses, with loss ratios and other key financial indicators being the best in thirty years. Had it not been for the four hurricanes in Florida last year, the industry would have had its best year since the 1950's. While state regulation can be improved, we should be cautious about making radical changes to a regulatory system that delivers for both consumers and insurers.

States Are Well on the Way to Achieving Modernization Goals in the SMART Act

Through testimony, meetings, and correspondence with the Financial Services Committee, NAIC members have consistently supported many of the regulatory modernization goals embodied in the draft SMART Act. We have a state-based action plan to achieve those goals that is on-time and on-target to achieve legitimate changes sought by the insurance industry. Like you, we want to accomplish needed modernization using the existing state regulatory system that has served our nation well for more than 100 years.

The NAIC's strong commitment to regulatory modernization is set forth in its modernization roadmap document, "Framework for a National System of State-Based Regulation". Here is an update on where we stand:

Life Insurance

- Where appropriate, NAIC and the states are working to achieve full regulatory uniformity to benefit both consumers and insurance providers. Marketing life insurance is an area where we agree with industry that greater uniformity is needed. To accomplish this, the NAIC negotiated development of an appropriate interstate compact, with full input from industry and consumer representatives. An interstate compact is the best way to get the job done while preserving effective state consumer protections.

- The NAIC finalized model legislation for the Interstate Insurance Product Regulation Compact in July 2003. The Compact creates an interstate commission that will develop national product standards for life insurance, annuities, disability income insurance and long-term care insurance products, as well as create a central point for insurers to file their products. The Compact becomes operational once 26 states or states representing 40% of the premium volume join the Compact.

- Since the NAIC adopted the model legislation in 2003, the Compact has been adopted by a growing number of states. In 2004, nine states enacted the Compact legislation (CO, HI, IA, ME, NH, RI, UT, VA and WV). So far this year, Compact legislation has been enacted in six more states (KS, ID, IN, MD, NE and WA). In two other states (TX and VT), the Compact legislation has been passed by the legislature and is awaiting the governor's signature.

- This means the number of states in the Compact will soon grow to 17, which represents approx 23% of the premium volume in this country. We expect this number to grow throughout the year. Compact legislation remains pending in a handful of other states, and we are optimistic about the chances for passage. Moreover, we anticipate the Compact will become operational in 2006. This will

be a remarkable achievement, considering the general rule of thumb for compacts is that it takes anywhere from seven to ten years to get them from the planning stage to becoming operational.

- The NAIC's Interstate Compact National Standards Working Group has developed 33 sets of standards for products that are covered by the Compact. There are 16 life insurance standards, 15 annuity standards, and standards for individual long term care insurance and individual disability income insurance. This preliminary planning will allow the Compact to become operational much more quickly once the requisite number of states have enacted the compact legislation. These standards were thoughtfully drafted and thoroughly vetted by regulators with input from state legislators, the insurance industry, and consumers.

Speed to Market

- Much progress has been made since 1999 to improve the situation for insurers regarding speed to market. While the effort is a work-in-progress that will continuously be enhanced and improved, there have already been many successes. In 1999, the NAIC's System for Electronic Rate and Forum Filings, commonly known as SERFF, was in its infancy. There were 1,009 product filings processed through SERFF. Last year, SERFF had grown to 151,064 filings with an average filing turnaround of 23 days. The SERFF system offers a true speed-to-market opportunity to the 1,575 insurers that choose to use this optional regulatory efficiency tool.

- Not all insurers choose to use SERFF, despite the speed to market that it offers. One of the great state regulatory successes is development and implementation of filing review standards checklists. These checklists have been implemented in 46 states, the District of Columbia, and Puerto Rico. They provide the tools needed for insurers to assemble product filings that comply with state regulatory and

consumer protection requirements. The checklists contain concise lists of the steps an insurer needs to take to submit a compliant product filing. Those insurers choosing to use the checklists have given regulators positive feedback, and report improvements in the timeliness of the product approval process.

Company Licensing

- Efforts to improve standardization and consistency in the licensing of insurers has made significant progress. A best-practices handbook was adopted by the NAIC this year. Among other things, it provides for states to rely on the domiciliary state regulator when assessing the financial condition and executive management of an insurer, and to apply a risk-based methodology for assessing the qualifications of an applicant insurer. A model law on company licensing was initiated this past week at the NAIC Summer National Meeting in Boston. We have already designed a uniform application and electronic system for facilitating the licensing process.

- Regulation and financial reporting of reinsurance transactions has taken center stage at the NAIC during the past three months. The NAIC moved quickly to design enhanced disclosures for evaluating the use of finite reinsurance by property/casualty insurers. Additionally, the NAIC has been working effectively with U.S. Treasury staff and European regulators regarding the requirement that non-U.S. reinsurers post collateral supporting their liabilities to U.S.-based insurers. State insurance regulators have also been cooperating with the European Commission and its member countries to assist with implementing the EU Insurance Group Directive.

- Financial solvency monitoring and insolvency regulation continues to consume a significant portion of the NAIC agenda. Insurance financial reporting is being further refined to allow earlier detection of troubled insurers. State regulators are adopting a more risk-focused assessment framework toward assessing the

solvency position of insurers. Capital adequacy standards are evolving to "principle-based" versus the present formulaic approach. Insurance regulators are pro-actively considering how best to improve the industry's corporate governance practices.

- The NAIC has also been working effectively with members of the International Accounting Standards Board. During our Summer National Meeting in Boston, the NAIC Financial Condition Committee began deliberations on a comprehensive model act designed to modernize and strengthen the authority of insurance regulators regarding insurer conservation, receiverships, and liquidations. The new model, which is expected to replace the Uniform Receivership Law, will be presented to the full NAIC membership in September.

Market Conduct

- The NAIC is implementing a more effective and efficient market regulatory system based upon the following five primary elements: (1) centralized data collection, (2) structured and uniform market analysis, (3) uniform examination procedures, (4) interstate collaboration, and (5) broader regulatory responses to address general business practices, with specific provisions for targeted examinations.

- To facilitate state collaboration, the NAIC created a Market Analyst's Scorecard to track state actions for the following areas: (1) appointment of a market analysis coordinator, (2) completion of core complaint analysis, (3) coordination with the NAIC's Market Analysis Working Group regarding nationally significant companies, and (4) participation in the NAIC's Market Information Systems. Forty-eight states and the District of Columbia successfully completed the goals outlined in the Market Analyst's Scorecard.

- In 2004, the NAIC published the Market Analysis Handbook to coordinate state market analysis nationally. A critical component is interstate collaboration on consumer problems through the NAIC's Market Analysis Working Group, which was formed in 2003. Increased analysis and coordination have resulted in fewer duplicative regulatory efforts.

- In 2002, the NAIC adopted a comprehensive set of Uniform Examination Procedures, to which 42 states have certified compliance. Uniform procedures make exams more efficient and enhance state collaboration.

- In 2006, the NAIC expects to develop more uniform and better standards for: (1) market analysis, (2) regulatory responses, (3) state authority to analyze, investigate and examine companies and (4) interstate collaboration. The NAIC Market Conduct Annual Statement Project, which will further unify and coordinate state market conduct data requests, became permanent in 2005 with involvement by 17 states. Additional states are expected to participate in 2006.

- Last year, the NAIC adopted a Market Surveillance Model Act providing that targeted or "for cause" examinations be conducted by states using uniform procedures based upon patterns or practices that deviate significantly from industry norms.

Producer Licensing

- As of today, 42 states have satisfied the producer licensing reciprocity mandates in the NARAB section of the Gramm-Leach-Bliley Act.

- The NAIC has moved well beyond the reciprocal licensing required by the Gramm-Leach-Bliley Act towards the NAIC's goal of achieving licensing uniformity. The NAIC adopted a uniform application that is used for both resident and non-resident licensing. Thirty-two states and the District of

Columbia are using these applications for resident licensing, while forty-eight states and the District of Columbia are using these applications for non-resident licensing. Another example of state uniformity and coordination is the well-established State Producer Licensing Database, which facilitates faster licensing of non-resident applicants, as well as better tracking and coordination of regulatory actions among states. Every state and the District of Columbia participate in this database, which has been the centerpiece for creating greater efficiency in producer licensing and greater consumer protections.

- The NAIC is also moving well beyond the Gramm-Leach-Bliley mandates calling for licensing reciprocity in a paper environment. The NAIC continues to call for licensing uniformity in a modern-day electronic environment that addresses: (1) licensing qualifications, (2) pre-licensing education, (3) producer licensing testing, (4) background checks, (5) application process, (6) appointment process, (7) continuing education requirements, and (8) limited line uniformity.

- The NAIC has partnered with producers and companies to create the National Insurance Producer Registry (NIPR), which offers an expanding array of electronic services to facilitate multi-state licensing, appointments, and other producer-related business. Use of the NIPR has grown impressively.

- The NAIC continues to seek enhanced state access to the FBI database and resolve the federal prohibition against sharing such information among the states.

- The NAIC has electronic procedures in place for: (1) appointments and terminations, (2) application process for non-residents, (3) automatic notice of regulatory actions to states, (4) creation of a national producer number, and (5) electronic home state certifications for non-resident licensing.

- The NAIC and state insurance regulators have been working with the Federal Emergency Management Agency (FEMA) to assist it with its mandate contained

in Section 207 of Senate Bill 2238. This provision requires the Director of FEMA to work with states and the insurance industry to establish minimum training and continuing education requirements for insurance producers that sell flood insurance.

- The NAIC and state insurance regulators have also been working with the Federal Crop Insurance Corporation's Risk Management Agency (RMA) on producer and adjuster licensing. The RMA would like states to provide a limited lines license for the nation's more than 25,000 crop insurance agents. Fifteen jurisdictions already have a limited lines license, and discussions are underway on improvements to agent education, testing and continuing education. Licensing of crop insurance adjusters is also being discussed.

Impact of the SMART Act on State Consumer Protections

As currently structured, the SMART Act would result in regulatory gaps and market uncertainty for both insurance companies and consumers because it broadly preempts existing state laws and regulations used to supervise insurance companies and producers. The NAIC and its members know very well from hands-on experience that modernizing complex regulatory rules in these areas must be handled very carefully, with full and ongoing input from regulatory experts, consumers, and industry. Even well-intended and seemingly benign federal laws can have a substantial adverse impact on state laws and regulations that protect insurance consumers if they preempt state regulatory authority. This has already been proven by ERISA regulations and the National Flood Insurance Program.

In December 2004, the NAIC undertook a thorough review and analysis of the draft SMART Act using seven teams of insurance commissioners and senior state staff totaling 117 regulatory experts. The SMART Act's provisions were evaluated to determine their potential impact on the NAIC's modernization roadmap and state regulatory authority. A final version of the NAIC SMART Act Review Team report was transmitted to Chairmen

Oxley and Baker on April 22, 2005. The report focuses on concerns about the negative impact of the SMART Act's fundamental structure, which would employ broad federal legal preemptions and second-guessing of state regulatory decisions to achieve its goals.

Here are the summary findings of the NAIC Review Teams report (a complete copy of the report is attached at the end of this testimony):

1. The SMART Act would substantially and negatively impact state regulatory authority to supervise property/casualty, life, and health insurance, as well as reinsurance, by establishing federally-mandated standards and preempting state laws. As a result, insurance consumers would be denied the benefits of important state consumer protection laws and regulations.

2. The SMART Act would create regulatory confusion in insurance markets by subjecting state regulatory authority to second-guessing and possible interference by a new federal entity called the State-National Insurance Coordination Partnership. In addition to raising a host of serious legal and practical concerns regarding its composition, powers, and administration, this Partnership would encourage time-consuming and expensive litigation by persons who disagree with state regulatory actions. The legitimacy of state actions would hang under a cloud of doubt until a final resolution is reached in federal courts, causing uncertainty in the marketplace.

3. The SMART Act would remove the ability for independent judgment and action by state regulators to protect consumers under state laws and regulations in such important areas as supervising rates and conducting market conduct exams. Even in Illinois, which has often been cited by SMART Act proponents as the model rate system for all states, the Act would undercut or negate important provisions of state law that make the Illinois rate system work.

4. Most specified time limits for states to implement the SMART Act's requirements are unrealistically short. In addition, many of the Act's provisions seem unworkable or detrimental to state consumer protection efforts.

5. Federal legislation is generally not needed to implement the various provisions of the NAIC's Roadmap for regulatory modernization. However, the NAIC welcomes federal legislation that would permit equal access by all state insurance regulators to the FBI's criminal database, enable sharing of confidential regulatory information, and grant states equal receivership powers with the federal government

The NAIC wants to play a positive role in helping the House Financial Services Committee evaluate the draft SMART Act by providing technical assistance as regulatory experts and policy input as state officials. However, the NAIC cannot support any federal legislation that includes broad federal preemption of state consumer protection laws or federal supervision of state insurance regulation. Unwise federal interference could undermine or negate state consumer protections, while also causing confusion among insurers, producers, and policyholders concerning "who is in charge" of important regulatory decisions.

As the SMART Act has not yet been formally introduced as a bill, it is premature for the NAIC to take a position to support or oppose it. However, we have expressed the NAIC's fundamental concerns regarding the structure and impact of the SMART Act during meetings and correspondence with Members and staff of the Financial Services Committee. For these reasons, the NAIC has long expressed concerns about how an optional federal charter for insurance companies would erode state authority and undermine consumer protections.

Conclusion

The system of state insurance regulation in the United States has worked well for 125 years. State regulators understand that protecting America's insurance consumers is our first responsibility. We also understand the difference between regulatory oversight of personal lines and commercial lines, and are taking necessary steps to modernize regulatory procedures for the benefit of consumers.

We ask Congress and insurance industry participants to work with us to implement the NAIC's modernization initiatives through the state legislative system. We believe that is the most practical way to achieve necessary changes quickly in a manner that preserves state consumer protections for the benefit of consumers. The state process rewards the citizens and consumers in each state by giving them control over important aspects of insurance and claims procedures that affect their financial security in the communities where they live.

The NAIC and its members have cooperated fully over the years with important inquiries by Congress into the adequacy of the state regulatory system. We believe these inquiries have demonstrated clearly that local and regional state regulation of insurance is the best way to meet the demands of consumers for this unique financial product. We will continue to work with Congress and within state government to improve the national efficiency of state insurance regulation while preserving its longstanding dedication to protecting American consumers.

Revised April 22, 2005

NAIC's SMART ACT REVIEW TEAM FINDINGS

CONTENTS

Analysis of the Draft SMART Act's Impact on the NAIC's Roadmap: *"Framework for a National System of State-Based Regulation"*

Background

- In December 2004, the NAIC's Government Affairs Task Force decided that state insurance regulators should undertake a detailed analysis of the Oxley-Baker SMART Act discussion draft released in August 2004. The SMART Act is a collection of many different regulatory goals combined under the umbrella of a central federal enforcement mechanism that preempts conflicting state laws and regulations.

- The proposed SMART Act is lengthy and complex, with 17 separate titles covering a broad range of state insurance regulatory practices. These include producer licensing, company licensing, commercial and personal rate supervision, reinsurance, surplus lines insurance, regulatory information sharing, access to FBI criminal data files, life insurance, viatical transactions, and health insurance. In each area, the SMART Act would require that states adopt uniform regulatory practices that meet specific federal requirements. The Act's regulatory standards and practices would be enforced by federal preemption of conflicting state laws. A new federally-mandated "partnership" organization would be created to supervise implementation of the Act's statutory requirements.

- The Government Affairs Task Force approved using teams of state regulatory experts to review specific sections of the SMART Act in order to assess their impact on state insurance supervision authority and regulatory modernization efforts. As a result, seven review teams were created to evaluate and issue separate reports on each title of the SMART Act discussion draft. The NAIC review teams were comprised of 117 commissioners and senior regulatory experts from state insurance departments and the NAIC.

- The NAIC's ongoing state regulatory modernization program, entitled *"Framework for a National System of State-Based Regulation"* (nicknamed the NAIC Roadmap), was used as the focal point for evaluating specific provisions of the draft SMART Act. The review teams evaluated how the SMART Act's provisions would affect state implementation of the NAIC Roadmap and state supervision authority generally if the Act became law. Each SMART Act review team was asked to evaluate its assigned sections of the Act with the goal of answering three basic questions:

  (1) Are the NAIC's Roadmap goals adequate?
  (2) Is federal legislation necessary to reach NAIC's goals?
  (3) How does the SMART Act impact state regulation?

Summary of Key Findings by the SMART Act Review Teams

6. The SMART Act would substantially and negatively impact state regulatory authority to supervise property/casualty, life, and health insurance, as well as reinsurance, by establishing federally-mandated standards and preempting state laws. As a result, insurance consumers would be denied the benefits of important state consumer protection laws and regulations.

7. The SMART Act would create regulatory confusion in insurance markets by subjecting state regulatory authority to second-guessing and possible interference by a new federal entity called the State-National Insurance Coordination Partnership. In addition to raising a host of serious legal and practical concerns regarding its composition, powers, and administration, this Partnership would encourage time-consuming and expensive litigation by persons who disagree with state regulatory actions. The legitimacy of state actions would hang under a cloud of doubt until a final resolution is reached in federal courts, causing uncertainty in the marketplace.

8. The SMART Act would remove the ability for independent judgment and action by state regulators to protect consumers under state laws and regulations in such important areas as supervising rates and conducting market conduct exams. Even in Illinois, which has often been cited by SMART Act proponents as the model rate system for all states, the Act would undercut or negate important provisions of state law that make the Illinois rate system work.

9. Most specified time limits for states to implement the SMART Act's requirements are unrealistically short. In addition, many of the Act's provisions seem unworkable or detrimental to state consumer protection efforts.

10. Federal legislation is generally not needed to implement the various provisions of the NAIC's Roadmap for regulatory modernization. However, the NAIC welcomes federal legislation that would permit equal access by all state insurance regulators to the FBI's criminal database, enable sharing of confidential regulatory information, and grant states equal receivership powers with the federal government

The SMART Act's Impact on State Regulatory Authority

TEAM #7
General SMART Act Legal Issues Regarding State Insurance Regulation, Federal Preemption, Federal Oversight Entity, and Rate De-regulation

The current draft of the SMART Act presents myriad legal issues, ranging from fundamental constitutional issues concerning the relationship between the federal government and the states to a variety of issues presented by the draft language of the statute itself. What follows is an attempt to identify and categorize the legal issues presented in the draft Act. It is not intended as an exhaustive list of those issues, nor is it intended to provide answers to the fundamental questions presented.

Federal Preemption of State Laws and Regulations

The SMART Act draft provides for extensive use of federal legal preemption as a means of achieving uniformity. Preemption of state law is expressly called for in the following Titles: Title II (Market Conduct and Uniform Standards), Title III (Insurer Licensing), Title IV (Producer Licensing), Title V (Life Insurance), Title VI (Commercial Property and Casualty Insurance), Title VII (Personal Lines Property and Casualty Insurance), Title VIII (Surplus Lines and Independently Procured Insurance), Title IX (Reinsurance), Title XI (Viaticals), Title XIII (Receivership), Title XIV (Financial Surveillance), Title XV (Partnership), and Title XVI (Creating Competitive Insurance Markets).

Examples of Federal Preemption in the SMART Act

The draft Act uses different mechanisms to effect the preemption of state law. Several examples are set out below.

1. The most prevalent form of preemption language requires that states must either enact a model or updated laws within a certain time period (generally three years) or their laws governing the same area will be preempted. Preempted state laws would be replaced by standards prescribed in the model law, even if not adopted by the particular state, or as specified in the Act. (Titles II, III, IV, V, VI, VIII, IX, XI, XIII and XIV.)

2. To the extent any state law would prohibit the state insurance commissioner from complying with Title II concerning Market Conduct Uniform Standards, that state law is preempted. §207(c).

3. States are prevented or face restrictions from exercising their authority to conduct examinations, take enforcement action, collect examination fees or assessments, deny licenses, or collect license fees unless they meet certain standards. The following provisions are examples of this form of preemption:

   §202(a)- For Cause Examinations
   §203(c)- Collection of Examination Fees

§301(d)- Insurer Licensing
§401(b)- Producer Licensing
§401(c)- Licensing Fees

4. States are not allowed to use residence or place of business as a basis to impose requirements limiting or conditioning activities. §401(b).

5. States are restricted from imposing fee increases or establishing new fees in those areas where required laws have not been put in place. §401(c) (Producer Licensing Fees); §601(c) (Property & Casualty Filings); §701(c) (Personal Lines Filings). Titles VI and VII also include proposed restrictions on a state's ability to implement fee increases or new fees unless the state demonstrates at a public hearing that the direct costs of insurance regulation are expected to exceed the sum of all insurance-related fees or insurance specific taxes. §601(c)(2); §701(c)(2).

6. After a specific time period (i.e., two years from the effective date of the Act), states are restricted from exercising authority over any rate charged for an insurance policy by an insurer. (Title XVI)

Federal Standard-Setting in the SMART Act

Although some proponents of the SMART Act describe its provisions as merely an opportunity for states to develop their own uniform standards of insurance regulation, there are multiple instances where federal standards are in fact directly imposed on the states, either by having those standards set forth in the Act or by requiring the inclusion of certain standards within a specified model act. Examples include:

1. §201(c) sets a restrictive standard of home state deference unless there is a "for cause" examination.

2. §202(a) sets a restrictive examination threshold under which a state may call a "for cause" market conduct examination only if there is an immediate danger or identification of patterns or practices that deviate significantly from the norm or pose a potential risk.

3. § 203(c) establishes a new procedural argument under which a multi-state insurer shall not be liable to pay any fee, assessment, or other charge to a state that conducts a "for cause" market conduct examination that was not performed in material compliance with Title II.

4. §301(a-d) provides that a non-domiciliary state may only request certain information from an insurer licensed in another state, and may only grant or deny licensure based on standards set out in the Model Licensing Act.

5. §501(c)(3)-(d) sets out standards a state must use for approving any life insurance policy form in the event that state does not use the Uniform Multistate Filing System.

6. §600(2) dictates that required commercial and property filing standards include certain elements, including recognition of single-state governance of policy form requirements.

7. §601(b) sets standards for a nationwide filing system.

8. §803(c) sets out federal standards for the allocation of premium taxes among the states.

9. Subtitle B of Title XIII is essentially a detailed federal standard for insurance receiverships.

Legal Issues Regarding Smart Act Preemption Of State Insurance Laws

Two sets of legal issues that give rise to numerous questions and concerns are presented by the draft SMART Act. First, there are a variety of constitutional issues presented, and second, there are issues related to the specific language used in the draft Act. These two sets of issues are addressed in turn below:

1. Constitutional Issues Related to Preemption

a. The Full Faith and Credit Clause (Art. IV, Sec. 1) requires that each state give full faith and credit to the acts of every other state. The proposed "majority interpretation" requirement (§209(7)) that governs when state law will be preempted by the SMART Act or a specified Model Act is potentially in conflict with this constitutional premise. Using the definition of "majority interpretation" in the draft Act, the interpretation of 10 state courts or 10 insurance departments could override the interpretation of the highest court of an individual state. There are questions as to whether Congress has legal authority to enact a legislative exemption from the Full Faith and Credit Clause or create a circumstance in which 10 states would determine the law of the land. There is also a question as to whether a "majority interpretation" means a majority of 10 insurance departments, i.e., six of 10.

b. The Tenth Amendment provides that all powers not delegated to the federal government are reserved to the states. The doctrine of "Cooperative Federalism" differentiates between permissible federal laws that regulate state activities and impermissible federal interference with state regulation of private parties. Compare *New York v. United States*, 112 S. Ct. 2408, 505 U.S. 1434, 120 L. Ed. 2d 120 (1992) with *Printz v. United States*, 521 U.S. 898, 117 S. Ct. 2365, 138 L. Ed. 914 (1997). There are concerns that the draft Act, specifically Titles VI and XVI,

essentially requires states to enact federal laws, enforce federal statutes, and enforce an unfunded federal program.

c. Various provisions of the draft Act establish federal "goals" for state law developments. See, e.g., §801(b) concerning goals for state tax obligations on surplus lines insurance transactions. There are concerns as to whether creating a quasi-judicial body like the Partnership or granting NAIC the power to determine whether those goals have been met constitutes a legislative incursion into judicial powers in violation of the doctrine of Separation of Powers.

d. The draft Act provides in several instances that, upon a State's failure to act on certain provisions, federal law will prohibit state collection of certain fees and taxes. There are concerns as to whether the Commerce Clause enables federal law to impose such a broad restriction on the general taxing powers of states.

e. Pursuant to Section 1037 of the draft SMART Act, the United States Government Accountability Office (GAO) would be given an overly broad grant of authority to conduct audits of state insurance departments, i.e., to gain access to all records and information for the purpose of conducting an audit. If a State insurance regulator refuses to grant access to the GAO, Section 716 of Title 31 of the U.S. Code allows the GAO to subpoena the requested records. Section 716 also authorizes the GAO to bring a civil action to enforce the subpoena. For those failing or refusing to obey a court order requiring production of records, a court may issue a citation for contempt of court. As state insurance departments are legally authorized, administered, and funded under state laws, there are concerns such actions by GAO would unconstitutionally violate a state's sovereignty.

2. Legal Issues Regarding Application of Preemption Language

a. Who determines whether a state law is "substantially similar" to a Model Act? Is "substantially similar" the same as "materially identical"? (See e.g. §204(d)) What does "inconsistent" mean? (See e.g. §204(d)(2)). If a law, regulation or provision is inconsistent, does that also mean it is not "materially identical" or "substantially similar"?

b. Who determines whether a state law is different or in conflict with a Model Act? (See e.g. §301(f)(3)(B)). Does "identical" mean identical in every respect? (See e.g. §301(f)(2)). Is identical the same as "materially identical"?

c. Is the determination of substantial similarity made globally or on a section-by-section basis?

d. What is the effect of amendments by the NAIC to its Model Acts or by the states to their own regulations?

e. Are the Model Acts themselves preempted when there is no corresponding draft SMART Act provision?

f. What constitutes a "majority interpretation"? (§209(7)). In defining "interpretations" under Title II, the SMART Act draft refers only to opinions of state insurance commissioners, and limits those interpretations to legal opinions, letters, and bulletins. Do rules or other decisions promulgated by a state insurance department qualify under the Act? What about opinions of state courts and state attorneys general? Will interpretations of an insurance commissioner control even if superseded by other state authorities?

g. In providing that states must follow the majority interpretation of states, the draft does not define when an interpretation is final as to a particular state, or when the other states may rely upon that interpretation. What if 10 states have one interpretation and 10 other states have a different interpretation? Once a majority interpretation is established, does the requirement that all states follow that interpretation prohibit any state from ever adopting a contrary interpretation? If so, how can a majority interpretation ever be amended or resolved? As mentioned earlier, there is a question as to whether a "majority interpretation" means a majority of 10 insurance departments, i.e., six of 10.

h. If the interpretation of an insurance commissioner is changed by a trial court, reversed on appeal, and then sent to the Partnership, does this interpretation change the ten-state threshold regarding a majority interpretation and result in conflicting regulatory actions?

i. Title IV prohibits a non-resident state from denying licensure for non-resident producers on any ground other than failure to hold a resident license or failure to pay license fee. Does limiting the authority of a non-resident state to deny licensure also limit the nonresident state's right to revoke a license for other grounds, such as fraudulent acts committed in a nonresident state?

Federal Supervision of State Regulation Using the "Partnership" (Title XV)

Title XV of the SMART Act creates a separate federal entity – termed the "State-National Insurance Coordination Partnership" – that would play a significant role in developing and overseeing the relationship between state insurance regulation and federal goals. Membership of the Partnership would consist of three insurance commissioners, designees from the SEC, Treasury, and the Federal Reserve, and a commissioner-

nominated, non-voting Chair approved by the President. Although the Chair must have extensive insurance industry background, he or she is not required to have any insurance regulatory experience and will not be a state or federal government official. The Federal Advisory Committee Act will apply to meetings of the partnership. Expenses of the partnership are to be paid in equal portions by the state and federal government members.

Primary responsibilities of the Partnership include: (a) promoting uniformity, (b) advising the President and Congress on international insurance issues and federal financial policy affecting the insurance marketplace, (c) making determinations regarding state compliance with the Act, (d) mediating and resolving conflicts among governmental agencies, and (e) conducting arbitrations of inter-agency conflicts. The Partnership would have the authority to: (a) hold hearings and take testimony, (b) conduct non-binding arbitrations, (c) request any information from state insurance departments that may be of use to the Partnership in carrying out its duties, (d) issue interpretations and participate in court proceedings, with equal weight given to its interpretations, and (e) make determinations that could result in the preemption of state laws.

Arbitrations presided over by the Partnership include disputes among or between federal and state agencies and disputes between the Partnership and a given state. After an arbitration decision has been made, either the Partnership or the state may petition the United States Court of Appeals for the D.C. Circuit to be heard on the outstanding issues. Finally, in the case of a conflict regarding whether a state law, rule, regulation, order or interpretation is properly treated as preempted under the Act or is in compliance with the standards established by the Act, either the state or the Partnership may seek expedited judicial review of the Partnership's determination in the U.S. Court of Appeals for the D.C. Circuit.

The establishment and operation of the Partnership present a number of legal issues. Some of these issues are presented below. The questions raised below are based on a preliminary review of the draft legislation. Additional issues are likely to be identified as the analysis becomes more refined over the next few months.

Legal and Operational Issues Related to the Partnership

a. "Partnership" is a well-defined term in statutory and common law, and its principal utility in the law is to describe the relative economic interests of the participants in the arrangement. Because this is a not-for-profit entity without assets, the term may create ambiguities. There are concerns about these ambiguities.

b. The Partnership is described as an "independent establishment." What does this term mean? Will the Partnership be governed by the operational rules that govern a federal agency? If not, what rules will apply? There are no express provisions in the draft Act governing compensation, job titles, etc. How will those issues be resolved?

c. Although the activities of the Partnership are to be governed by the Federal Advisory Committee Act, the powers granted to the Partnership to issue interpretations, make policy decisions, determine compliance, conduct arbitrations and mediations, and initiate legal actions are not consistent with an advisory body. Is it normally within the scope of a federal advisory committee to have these powers?

d. Does formation of the Partnership and the requirement that state commissioner members of the Partnership perform certain duties and pay certain costs amount to a commandeering of a state and its assets to administer a federal law? Aside from the legal issues presented, are the states and/or the NAIC prepared as a practical matter to make the required financial commitment to the Partnership?

e. The draft SMART Act provides that states may be parties to arbitrations or injunctive actions initiated by the Partnership. What court would have jurisdiction over those proceedings? Would initiation of such actions violate the Eleventh Amendment?

f. With regard to the Model Laws and other standards that will be used to determine uniformity, there is no clear guidance in the draft Act regarding the criteria or procedures used to determine compliance with those standards. For example, §603(f) states that the Partnership in consultation with the NAIC will determine if the states have met a SMART Act goal, but it is unclear if the Partnership has the authority to make individual state preemption determinations or if this is merely an aspect of its own opinion to be included in an advisory report to Congress. How will compliance with SMART Act standards and goals be determined and what criteria will apply?

g. There are concerns as to whether the draft legislation essentially makes the Partnership a "regulator of state insurance regulators" as a result of its power to make determinations regarding preemption of state law, its ability to request information from state insurance departments, and its arbitration role that would effectively create a super insurance regulatory body.

h. Given the powers identified above, as well as the ability of the Partnership to maintain an office and hire staff, the Partnership appears to be a precursor to a federal insurance regulator.

Mandatory Federal Rate De-Regulation (Title XVI)

Title XVI provides that after the expiration of a two-year period, no state may require the approval or prior review of any rate charged for an insurance policy by an insurer. A flex-band phase-in will be incorporated for covered lines to phase in competitive rating. The flex-band will be based upon the increase or decrease in the aggregate rate for all such coverages. The flex-band will not apply on an individual insured basis, and an insurer may make only one rate filing during any 12-month period. The flex-band will be 7% during the first 12-month period, and 12% during the second 12-month. Credit insurance,

title insurance, mortgage insurance, gap insurance, medical malpractice insurance will be excluded from the covered lines of insurance. Health insurance will not be excluded.

Nothing in Title XVI preempts States from requiring the informational filing of rates; from establishing or recognizing rating or advisory organizations; and nothing in this section preempts State statutes, rules, regulations or orders that prohibits the use of race, color, religion, creed, ethnicity, or national origin as an underwriting or rating factor or classification.

In general, the SMART Act as currently drafted moves property and casualty rates to a file and use open competitive rating environment. It does so, however, without any fail-safe mechanism in case competitive forces are not working to serve the interests of the insurance buying public. Most state competitive rating laws have a fail-safe mechanism that reinstates a form of rate regulation if competition is found to be lacking. There are many examples of instances where competition among insurers has been found to be deficient. Under the SMART Act, there would be no remedy if that were to occur. The Act also does not define what level of competitiveness needs to exist or how one is to determine if a market is truly competitive. Further, the SMART Act does not have a remedy if a policyholder is aggrieved by a rating action taken by an insurer. This is an important element that gives the insurance buying public some redress if an insurer has misclassified the risk or otherwise charged an inaccurate premium.

Several examples follow showing how the SMART Act would have a negative impact on state rate regulatory frameworks.

Examples of SMART Act's Negative Impact on Rate Laws in New Hampshire, Illinois, Texas, and Ohio

Title XVI would have a negative impact on a number of important state insurance laws. For example, New Hampshire uses a file-and-use or use-and-file approach, except for workers' compensation, and more importantly allows the existence of competition to be the primary regulator of rates. Implementing a flex-band system, as described in the draft legislation, would very likely be viewed as a step backwards for insurers doing business in the state.

Illinois and its rating system have often been cited by proponents of the SMART Act as the model for other states to follow. Yet in Illinois and other states, Title XVI would preempt laws that provide important protections against excessive rates, unfairly discriminatory rates, inadequate rates, and inadequate notice of premium increase, etc. The authority of the state to regulate the adequacy (from a financial solvency perspective) or fairness (from an insurance classification perspective) of rates is crucial to the ability of the state to maintain an insurance marketplace based on competition while providing for financial solvency and consumer protections necessary to oversee the marketplace. Similarly, it is the policy in Illinois and other states to permit market driven rating only to the extent a truly competitive marketplace exists.

1) **Illinois** – Following are specific examples of Illinois law that would be preempted under the draft SMART Act:

a. *Excessive rates:* Illinois law allows the Director to disapprove a workers' compensation rate if the rate is excessive. However, by definition, a rate in a competitive workers' compensation marketplace is not excessive. The authority to disapprove a rate in a noncompetitive marketplace is crucial to the effective regulation of this market because a marketplace cannot operate to establish fair rates in the absence of true competition. (See 215 ILCS 5/456)

b. *Unfairly Discriminatory Rates:* Illinois workers' compensation law prohibits price differentials that fail to reflect equitably the differences in expenses and losses. A rate may be unfairly discriminatory if different premiums result for policyholders with like exposures and similar expenses. (Id.)

c. *Unfair Practices:* Illinois law allows the Director to take action against any company when the Director has reason to believe that any method of competition is unfair or that an act or practice is unfair or deceptive, or that a proceeding in respect thereto would otherwise be in the public interest. The Director's authority includes the authority to identify and define unfair practices not already explicitly defined and prohibited, and to order their discontinuance. (See 215 ILCS 5/427)

d. *Inadequate Rates:* Illinois law prohibits workers' compensation rates from being inadequate. A rate is inadequate if it is clearly insufficient to sustained projected losses and expenses in a class of business to which it applies and the use of such a rate may have the affect of substantially lessening competition or the tendency to create a monopoly in any market. (See 215 ILCS 5/456)

e. *Long Term Care Insurance:* In Illinois, long term care rates must be approved before the policy can be sold, and rate increases must be approved as well. There is ample evidence from recent experience to show that an overly competitive market can actually hurt companies and consumers. There have been cases where companies charged low initial rates to "buy" market share, rates that were driven by the desire to sell lots of policies, not by actuarial adequacy. However, long-term care policies may be in force for 20 or more years before any benefits are paid out. These products rely heavily on rates being adequate from the start. By the time it becomes apparent that premiums are too low the situation is irretrievable. Rate increases only mitigate a company's losses while forcing people who have had a policy for a long time to drop their coverage. In extreme cases, a company's solvency has been threatened. (e.g., Penn Treaty, Conseco Senior Health)

f. *General Powers:* The Director may take action against a company any time (s) he deems that such a proceeding is in the public interest. Such an action could be for rating purposes or other business practice. (See 215 ILCS 5/429)

g. *Conditions for Applicability of Increases to Existing Policies:* The draft Act contains provisions that would preempt more protective Illinois laws, specifically in the area of conditional renewals. The draft legislation allows for "conditional renewal" premiums, for insurers to mail renewal notices to the address shown in the policy, and to mail renewal notices 30 days prior to the renewal date. Illinois law does not allow "conditional renewal". The only reasons for which an insurer may change the premium after the renewal date are for a change in exposure or reinsurance cost not contemplated in the original quote. Illinois law requires companies to provide 60 days advance notice for any premium increase greater than 30%, or if the insurer imposes a change in deductible or coverage that materially alters the policy, which allows a commercial insured (whose business is more complex) time to shop the competitive marketplace. Illinois law requires insurers to mail notices to the last known mailing address.

2) **Texas** – Effective December 1, 2004, Texas changed to a file and use state. The draft SMART Act would impact the following Texas laws.

a. Under Texas Insurance Code Articles 1.02(b) (general application): "Rates used under this code must be just, fair, reasonable, adequate, not confiscatory and not excessive for the risks to which they apply, and not unfairly discriminatory."

b. Under Texas Insurance Code Article 5.13-2(4)(d) (P&C application): "Rates established under this article may not be excessive, inadequate, unreasonable, or unfairly discriminatory for the risks to which they apply."

c. Article 5.13-2 §5A (a) allows for prior approval of rates in these three circumstances:

- An insurer's rates require supervision because of the insurer's financial condition;
- An insurer's rates require supervision because of the insurer's rating practices; or a statewide insurance emergency exists;
- A statewide insurance emergency exists.

In Texas, inadequacy of rates was a problem until the late 1980's when a number of non-rate-regulated companies were acquired by MGA's and used to generate cash flow through the sale of large numbers of policies at below-market rates, only to end up in receivership within a short time. Texas law has since been strengthened to prevent these types of activities. However, with no provision for effective rate oversight, the SMART Act may effectively undo these improvements in Texas.

3) **Ohio** – The following is a list of Ohio insurance statutes that would be preempted if proposed Title XVI of the SMART Act were enacted:

a. 3935.03. Rating regulations -- General Requirements set forth - Actuarially sound rates meet the general requirements. Rates should result from an analysis of the company's own data, with consideration given to marketing and underwriting strategies, company operations, systems and policy writing constraints, targeted rates of return, and all other pertinent information.

b. 3935.04. Filing of rates and schedules with superintendent; procedure -- Requires that every form of a policy, endorsement, rider, manual of classification, rules, and rates to be filed. Establishes ratemaking statutory requirements; generally, a rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer.

c. 3935.05. Processing of filings -- Sets forth the process for the Superintendent to disapprove a filing that does not meet the requirements of section 3935.01 to 3935.17 of the Revised Code.

d. 3935.07. Deviation from rates filed by bureau -- Requires every member of a rating bureau to adhere to the filings made on its behalf by the bureau, but allows any member insurer to make written application to the Superintendent for permission to file a deviation. Establishes the procedure to review such applications.

e. 3935.10. Reporting loss and expense experience; interchange of data and co-operation with other states -- The Superintendent shall promulgate rules and statistical plans which shall be used thereafter by each insurer in the recording and reporting of its loss and expense experience, in order that the experience of all insurers may be made available at least annually in such form and detail as is necessary to aid the Superintendent in determining whether rating systems comply with the standards set forth in section 3935.03 of the Revised Code.

f. 3937.02. Basic provisions for rate making -- General Requirements set forth - Actuarially sound rates meet the general requirements. Rates should result from an analysis of the company's own data, with consideration given to

marketing and underwriting strategies, company operations, systems and policy writing constraints, targeted rates of return, and all other pertinent information.

g. 3937.03. Classifications; rules; rates; rating plan -- Requires that every form of a policy, endorsement, rider, manual of classification, rules, and rates to be filed. Establishes ratemaking statutory requirements; generally, a rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer.

h. 3937.04. Hearing on rates and filings -- Sets forth the hearing procedure when the Superintendent finds that a rate to which sections 3937.01 to 3937.17 of the Revised Code apply does not comply with those sections.

i. 3937.06. Deviation from filings -- Requires every member of a rating organization to adhere to the filings made on its behalf by that organization, but allows any such insurer to file with the Superintendent a uniform percentage decrease or increase to be applied to the premiums produced by the filed rating system.

j. 3937.12. Report of loss experience; interchange of rating plan data -- The Superintendent may promulgate reasonable rules for the reporting by each insurer of its loss experience, in order that such experience of all insurers may be made available, at least annually, to aid the Superintendent in determining whether rating systems comply with the standards set forth in division (D) of section 3937.02 of the Revised Code.

k. Additionally, the following Ohio statutes may be preempted:
 3937.22. Raising premium when insured not at fault prohibited
 3937.23. Premium increase restriction as to uninsured motorist accidents
 3901.20. Unfair or deceptive acts prohibited
 (Specifically 3901.21(M) defining, as an unfair or deceptive act, "unfair discrimination between individuals of the same class and of essentially the same hazard in the amount of premium, policy fees, or rates . . .")

The SMART Act's Impact On Health Insurance

TEAM #6
NAIC Roadmap: Health Insurance
SMART Act Titles XII and XVI

a. The SMART Act draft bill would definitely impact state regulation of health insurance. Section 1200(1) of the Act discusses uniform standards for internal and external reviews by insurance plans. This terminology is very specific to health insurance. (There is a question as to how broadly these provisions would

apply since "insurance plans" is not defined.) Section 1200(2) regarding an interstate compact for single point of filing and coordinated review of lines of insurance provisions specifically applies to lines of insurance other than those addressed in Title V (Life), Title VI (Commercial Property and Casualty) and Title VII (Personal Property and Casualty). Section 1601 on rate de-regulation applies to covered lines, and there is no exception for health insurance.

b. The impact of the SMART Act provisions on health insurance is quite substantial. For example, states now have a variety of requirements for internal and external reviews. Careful study of the issue is required so that existing consumer protections are not lost, since there are a variety of models to choose from, particularly on external review. These models range from the insurance commissioner being the ultimate arbiter of a claim denial to the insurance company setting up the review entirely on its own with no regulatory oversight. This matter is further complicated by a recent U.S. Supreme Court case on ERISA. The regulatory structure for external review must be carefully considered so that it does not violate ERISA.

c. The single point of filing and coordinated review of lines of insurance provisions in the SMART Act presume that an interstate compact is the best solution to deal with speed-to-market issues. Regulators, industry, and consumers have not agreed with that proposition regarding major medical insurance. The Act would require the states to set up a process that none of the players have concluded is in the best interests of anyone. Further, benefits and rates are driven by local factors, such as the demographics of the population and the composition of the provider community. Given those differences, this area may be less suitable for national uniform standards than other aspects of insurance. The NAIC has a thorough process for exploring common ground on various potential solutions on speed-to-market issues.

d. The most detrimental impact of the draft SMART Act is in Title XVI, entitled "Creating Competitive Insurance Markets." By phasing in total de-regulation of rates for all covered lines, including health insurance, the bill would effectively eliminate health insurance as an instrument of social policy. Although the health insurance system is not shaped exclusively by rate regulation, other requirements such as guaranteed issue, guaranteed renewal, and portable coverage would become almost meaningless if insurers were allowed to increase rates on individual consumers at any time, by any amount, and for any reason other than the handful of civil rights factors specifically enumerated in section 1601(d) (from which gender discrimination is absent, even for lines of insurance where there is no compelling actuarial justification for allowing sex discrimination). Such a fundamental change in national health care policy should be debated in the context of health care legislation, and not included in a bill whose purpose is to reform insurance regulation.

e. Section 1601(b), entitled "Protection of State Residual Market Requirements", provides that a state may not set rates for a residual market insurance entity that are less than the entity's expected losses (e.g. high risk pool). In other words, subsidization of a state high risk pool by assessment or otherwise would be prohibited. This provision vitiates the very purpose of a state high risk pool, which is to provide affordable coverage for the uninsurable. High risk pools would no longer be effective if such a provision became law. This provision also runs counter to HIPAA, which recognizes the NAIC model law (with its subsidization of pool losses) as an acceptable alternative mechanism for guaranteed issue in the individual market.

f. Legislation dealing with health insurance issues included in the SMART Act is typically handled by the House Energy & Commerce Committee rather than the Financial Services Committee.

NAIC Review Team Findings Regarding Specific Regulatory Practices Mandated by the SMART Act

The following sections present findings of Review Teams #1, 2, 3, 4, and 5. Those teams analyzed and reported on areas of the SMART Act that impact specific types of state insurance regulation.

TEAM #1
NAIC Roadmap: Company Licensing & Financial Surveillance Enhancements
SMART Act Titles III and XIV

Company Licensing

Federal legislation is not needed to reach national uniformity on company licensing.

Since the NAIC is already working successfully toward achieving national uniformity on company licensing, the SMART Act would have little impact on achieving this goal. Similarly, there would be little impact toward reaching the goal of streamlining the process for considering proposed mergers and acquisitions involving multiple jurisdictions due to the NAIC's modernization work in this area. The review team believes the NAIC's Financial Regulations Standard & Accreditation (F) Committee should consider amendments to NAIC's Accreditation Standards regarding company licensing and processes surrounding mergers and acquisitions. The original Regulatory Modernization Action Plan, adopted in September 2003, contemplated making such changes to Accreditation Standards.

Financial Surveillance

The SMART Act could introduce harmful ambiguity to accomplishing the NAIC Roadmap goals. Federal legislation is not needed in this area.

The NAIC's goals are adequate regarding review of corporate governance under the Model Audit Rule. The NAIC is currently in the process of implementing the risk-focused surveillance framework and passing amendments to the NAIC Model Audit Rule regarding the responsibilities of independent auditors. Federal legislation is not needed to implement the Model Administrative Supervision Act, as the model is expected to become part of the NAIC Accreditation Program.

The NAIC has already effectively accomplished national implementation of the Accounting Practices & Procedures Manual through development of a formal policy and communication strategy. Permitted practices are by nature rare exceptions to the codified body of statutory accounting. The SMART Act's requirement for notification of requested permitted practices has already been accomplished through a revision to the Preamble of the NAIC Accounting Practices and Procedures manual. This fact makes item (b)(6) of Section 1400 of Title XIV of the SMART Act redundant, since item (b)(5) requires adoption and implementation of the NAIC Accounting Practices and Procedures manual. Inclusion of this section in the SMART Act legislation is unnecessary.

There is no need for federal legislation regarding state examinations of insurers. Regarding different examination cycles among the states, it is unclear which cycle would be preempted in Section 1407, item (b) of Title XIV of the SMART Act. Ambiguity in the SMART Act could cause unintended consequences by hindering the ability of states to examine insurers.

TEAM #2
NAIC Roadmap: Surplus Lines, Reinsurance & Receivership
SMART Act Titles VIII, IX, and XIII

Surplus Lines

Either federal legislation, or another alternative such as an Interstate Compact, may be needed at some point to resolve conflicting state laws regulating multi-state transactions. The area where this will most likely be necessary is surplus lines premium tax allocation. Federal legislation might also be one option to consider to enable multi-state property risks to access surplus lines coverage in their home states under a single policy subject to a single set of requirements.

The draft SMART Act's timelines for implementing a centralized tax system and uniform eligibility standards are unrealistically short. The Act provides a period of 3 years to implement the central tax system, but does not actually create a central tax system that can be implemented. This is a complicated issue that will impact multiple agencies and

state revenues. If federal legislation is enacted in this area, there should be at least a minimum 5-year implementation period. Likewise, even if uniform surplus lines eligibility standards are accepted as a valid public policy goal at the federal level, the current lack of consensus on appropriate standards in this (inherently non-standardized) market makes a 2-year implementation period highly unrealistic.

As drafted, the bill also appears to preempt state restrictions on opening up the surplus market (especially for sophisticated commercial purchasers) to lines of insurance where there is consensus that surplus lines coverage is inappropriate, such as workers' compensation, health insurance, and life insurance. There is even an express reference to life insurance: Section 814(c)(2)(D) of the SMART Act refers to a purchaser that "procures its life insurance through the use of a risk manager."

Reinsurance

Federal legislation is not needed in this area. The NAIC's goals for implementing reinsurance reforms through the Credit for Reinsurance Model Act are the right approach. The SMART Act could have serious negative consequences on regulation of reinsurance compared with using the NAIC Roadmap process.

The primary concern with the substance of Title IX of the SMART Act is that it addresses uniform financial statement filings, deference to the home-state regulator, and a uniform solvency regime without addressing the critical issue of indirect regulation of foreign and alien reinsurers.

Federal preemption of state regulatory controls would have a significant impact on the regulation of reinsurers compared to enforcing uniformity for critical portions of the reinsurance regulations through the NAIC Roadmap. As drafted, the reinsurance Title of the SMART Act does not address reinsurance-specific items, but rather all licensed entities since there is no separate solvency or reporting regime for reinsurers versus primary insurers. It should also be noted that proposals to prevent "extraterritorial" regulation of reinsurance contracts could have serious unintended consequences. It is essential for the ceding insurer's state of domicile to have jurisdiction over some aspects of reinsurance contracts for purposes of solvency oversight, fraud prevention, and the administration of insolvent insurers' estates.

Receivership

Federal legislation is needed to establish parity between insurance receivership estates and federal bankruptcy estates. However, the SMART Act does not implement the federal legislative changes needed by NAIC, and instead would harm states by mandating and inefficient and outdated receivership law rather than the NAIC's Insurer Receivership Model Act.

As noted in the NAIC Roadmap, federal legislation will be needed to achieve parity between insurance receivership estates and federal bankruptcy estates regarding (1) the

applicability of liquidation bar dates to federal claims, and (2) tax-exempt status of receivership estates. However, these issues are not addressed in the SMART Act, and they affect different regulatory concerns that would be better addressed by targeted legislation. At least one of these issues is more likely within the jurisdiction of the Judiciary Committee.

The draft SMART Act would override the use of NAIC's greatly-modernized Insurer Receivership Model Act that is part of the NAIC Roadmap over the next four years. The incomplete and out-of-date receivership model in Title XIII of the draft SMART Act would increase costs, slow the liquidation process, make rehabilitations all but impossible, and cause claimants to be paid later and less (increasing frustration with and decreasing confidence in the insurance industry). Adding to its problems, the draft SMART Act uses only parts of an outdated receivership model that was at least highly integrated, complex and carefully drafted to balance competing interests. If parts of the model are used out of context (as is done in the draft SMART Act), then problems are likely to result.

TEAM #3
NAIC Roadmap: Market Conduct, Agent Licensing, & Antifraud
SMART Act Titles II, IV, and X

Market Conduct

The NAIC's Roadmap goals are generally adequate to achieve uniform market conduct standards. Federal legislation is not needed. On the surface, the SMART Act seems to share NAIC's goals. However, the specific requirements of the SMART Act would unduly restrict a state's ability to conduct specific market conduct exams and regulatory actions when needed.

Section 209(5) of the SMART Act defines market analysis in such a way that potentially limits a state's analysis to information that is filed schedules and other reports required under law to be submitted by an insurer on a regular basis, as well as other publicly available data. The NAIC does not believe market analysis should limited to information required under law to be submitted by an insurer on a regular basis. A state should collect and use data as the commissioner deems appropriate.

Pursuant to section 202(a) of the Act, a state may call a "for cause" examination if there is an immediate danger or identification of patterns or practices that deviate significantly from the norm or pose a potential risk, as long as the issue has not been addressed by another state in the past five years, or has been addressed by another state in the past five years but has not been appropriately addressed within a reasonable period of time by the insurer. The NAIC believes a commissioner should have the discretion to conduct targeted, on-site market conduct examinations when the commissioner determines that other market conduct actions are not appropriate.

Pursuant to section 203(c) of the SMART Act, a multi-state insurer shall not be liable to pay any fee, assessment, or other charge to a state for conducting a "for cause" market conduct examination that was not performed in material compliance with Title II. The NAIC believes it is inappropriate for an insurer to have the ability to nullify a state's examination findings because of a procedural argument.

Section 203(a) of the Act limits a state's authority to impose a sanction or fine to the extent the state's interpretation is not a majority interpretation. This subsection provides that no state conducting a market conduct examination may impose any sanction for a violation of a market conduct standard or requirement unless the standard or requirement is based on a majority interpretation. This is an unacceptable preemption of a state's authority to interpret and enforce its laws.

Section 201(c) of the SMART Act calls for home-state deference unless there is a "for cause" examination. While the NAIC recognizes the benefits of domestic deference, the NAIC also believes there are other appropriate forms of interstate collaboration.

Producer Licensing

Federal legislation is needed to assist states in gaining equal access to the FBI's criminal database for background checks. Otherwise, federal legislation is not needed to achieve national producer licensing.

While current federal law allows individual states to gain access to the FBI fingerprint database through law enforcement channels, states need broader federal legislation to authorize all other states and the NAIC to gain routine access for background checks and share information received from the FBI. Title X of the SMART Act provides for establishing an Antifraud Network that appears to provide states with the means to obtain and share criminal history record information with the NAIC and each other, although the process would be more complicated than that used by banks and securities firms.

The state implementation timeframes in the SMART Act are too short, especially in light of the fact that one of the biggest hurdles for states with the uniform standards is adopting the uniform renewal cycle. This could have some impact on how quickly states are able to adopt laws necessary to implement the uniform license cycles and synchronized renewal times. Apart from the overly aggressive timetable set forth in the SMART Act, states are already in the process of moving to electronic processing for both resident and non-resident applications and renewals.

The SMART Act raises concerns regarding its impact on the appointment process for state licensing directors and the exact requirements of a national producer database. The draft SMART Act would require changes to current uniform appointment procedures that are in place in almost all states currently processing appointments. The NAIC Uniformity Licensing Standards relating to the appointment process should be reviewed and updated so states could start making changes in their laws and rules to implement a quarterly electronic registration process. Most states use NIPR for initial appointments

and terminations, which are filed individually for each person seeking an appointment. Pursuant to the Producer Licensing Model Act, appointments occur within "within 15 days of an insurer contracting with the producer."

Finally, the SMART Act should be revenue neutral to the states, especially for producer licensing.

Anti-fraud

Federal legislation is needed in this area to implement the NAIC's Roadmap goals. Overall, Title X of the draft SMART Act should help implement and support the NAIC's regulatory modernization action plan. The SMART Act appears to provide for the sharing of public final disciplinary and formal enforcement actions, as well as direct sharing of "confidential supervisory information" among federal and state financial regulators. There are also protections for NAIC to handle and transmit regulatory information on behalf of state regulators.

The SMART Act draft also provides a new avenue for state insurance regulators to access FBI criminal database files for purposes of conducting background checks on persons seeking to be licensed as producers. However, this new grant of authority for states to gain access is not the same as the authority granted to banks and securities firms because it will involve a screening process to remove certain information from a person's file before it is given to a state regulator. In addition to practical problems associated with screening the criminal database files, the FBI has indicated that it is not prepared to operate a screening process as required by the draft SMART Act. These potential problems will need to be resolved if the Title X of the Act is to be effective.

TEAM #4
NAIC Roadmap: Life Insurance and Viatical Transactions
SMART Act Titles V and XI

Life Insurance

The review team noted a number of concerns with the SMART Act draft legislation that raised questions because the provisions were unclear. Team members could not envision how they would work within the framework of the Interstate Insurance Product Regulation Compact.

1. The group felt that defining "life insurance" to include two health products (long term care insurance and disability income insurance) will create confusion and lead to difficulty, especially in rating. First of all, if the Compact decided to expand its reach to other products, for example Medicare supplement insurance, this legislation might make that expansion difficult. Secondly, the fact that rates for long term care insurance and disability income insurance are included in the Compact argues for treating them differently, instead of calling them life insurance. Rates for health insurance products will vary in different parts of the

country, and the goals of uniformity urged in the SMART Act could be more difficult to achieve in this area. There is no mention of how these rating issues would be treated.

2. The legislation as drafted is confusing. Some review team members felt the legislation requires every state to change its laws to match the standards in the Compact. The NAIC's goal in developing the Interstate Compact was to avoid taking the time for each state to change the laws and regulations necessary to create a uniform set of product filing standards. If the SMART Act requires that states join the Compact and, in addition, put in place "updated" laws and regulations materially identical to the uniform filing standards of the Compact, the process will be very time consuming and difficult. The penalty provided in the SMART Act for not completing this task within a very short three-year period is severe. Even though a state has joined the Compact and companies can file products through the Compact for uniform adoption, state laws could be preempted, and file and use provisions put into effect. If the goal is the ability for companies to be able to file products in a uniform manner with the Compact, there seems to be no motivation to take away the ability of companies to file with the state a product that does not meet the uniform standards. Perhaps the state law provides for products with greater consumer protections. Perhaps state law allows products that do not contain all the consumer protections, but meet the needs of a particular consumer and are available at a reduced cost. Perhaps the state has a simplified filing or no-file law in place that a company would want to utilize. These provisions could greatly limit the flexibility of companies and states. The Compact provisions allowing for an opt-out from a standard could be made inapplicable because of the SMART Act.

3. The review team found the concept of "sophisticated purchaser" to be unclear and possibly unworkable. Insurers generally do no create separate forms for purchasers that meet the definition in the SMART Act. Does this legislation envision a complete review of the form for general use and an expedited review of the same form if the company indicates it will be used for sophisticated purchasers? The review team felt the differences for a sophisticated purchaser would be in the required disclosures, not the policy form provisions. Neither the SMART Act nor the Compact covers marketing materials.

4. The review team suggests changing the NAIC Roadmap goals to refer to an "electronic system" rather than SERFF. That would match the language in the SMART Act and would allow more flexibility in the development of the system used. If a better system is developed or the NAIC chose to change the name of the SERFF system, the Roadmap goals should not stand in the way. The focus should be on the concept of one unified electronic system for form filing.

5. The provisions of the SMART Act that talk about disapprovals of products are unclear. They apparently apply to state review of filings, rather than those made by the Compact. It is not clear who will make this "majority determination"

or on what standards it will be based. If the Compact works as intended, there will be few state filings, so state interpretations may not be easy to obtain. The "majority interpretation" provisions also may raise separation of powers constitutional concerns by purporting to invalidate judicial interpretations of a state's laws if contrary to a "majority interpretation" by other states' regulators.

Viatical Transactions

The SMART Act undercuts the NAIC model law in important areas by allowing the alternative adoption of the weaker NCOIL model. The Act is also unclear, and could tie the hands of viatical fraud investigators.

1. One problem that was immediately identified is the reference to the NCOIL model. A model was drafted by NCOIL after the NAIC adopted its model act, so in the parlance of the SMART Act, it is an "updated law." However, significant protections in the NAIC model are not included in the NCOIL model. Since much of the NCOIL model is based on the NAIC model, it will be difficult to determine if and when five states have adopted the NCOIL model, as state legislatures tend to pick and choose among provisions of the existing model, earlier versions, and amendments suggested by legislators and representatives from the viatical industry. The text on the top of page 9 of Title XI of the SMART Act was also subject to differing interpretation by members of the review team. Does "model act" mean either of those? Is the correct interpretation to consider (b) OR (c)(1) OR (c)(2)? The only positive part of this provision is that it seems to recognize the possibility that NAIC may need to update its model to address changes in the viatical settlement marketplace.

2. The provisions related to viatical fraud may have unintended consequences. The SMART Act seems to imply that viatical fraud occurs only in the sale of viaticated policies to investors. While the majority of publicity has occurred in that side of the transaction, the review team was concerned that the wording of the bill would tie their hands in investigating fraud in other parts of the transaction, or even put into question on-going investigations of viatical fraud. Allowing three years for a study of viatical fraud creates additional problems for existing investigations.

3. Because the SMART Act specifically excludes the bracketed sections of the NAIC model, which are related to the investment side of the transaction, the consumer protections of the model are preserved only for viators.

4. The provisions of the SMART Act that speak of uniform or reciprocal licensure of brokers as a goal are unclear. Currently some states allow all life insurance producers to act as viatical settlement brokers and some require a separate license. Would they be required to be reciprocal only where the laws are similar to their own?

TEAM #5
NAIC Roadmap: Commercial P&C, Personal P&C, and Price Controls
SMART Act Titles VI, VII, and XVI

Commercial Property/Casualty Lines

Implementation of the SMART Act Titles VI and XVI as currently drafted would be detrimental to consumers, industry, and state governments. These sections create a confusing and inconsistent regulatory framework that would overlay current state laws and remove state legislators from decisions regarding important public policy matters that could affect a state's economy. These include decisions regarding the use of a residual market mechanism to advance public policy decisions, the movement of advisory organization loss costs away from prior approval, and the elimination of local decisions regarding the appropriate regulatory framework for workers' compensation and other commercial lines of insurance.

Federal legislation is not needed in this area. States have done much to relax rate regulatory requirements for large commercial insurance purchasers over the last decade. Perhaps the one area where Congressional activity would be helpful is to require that states implement the concept of home-state governance of a multi-state policyholders' insurance policy.

Personal Property/Casualty Lines

The SMART Act Titles VII and XVI as currently drafted would be detrimental. They would overlay a confusing and inconsistent regulatory framework over current state laws and remove state legislators from any decisions regarding important public policy matters that could affect their constituents' well-being. In addition, the SMART Act draft leads to the absurd result of having commercial lines property and casualty rates more closely regulated than personal lines rates. Important consumer protections would be lost that provide adequate recourse for citizens aggrieved by the application of an insurer's rating systems.

Diversity to meet local market conditions is one of the strengths of state regulation. This is particularly true for homeowners and personal auto insurance coverage. State demographics and markets vary widely. Urban areas face different market conditions than do rural communities, and sometimes they call for different regulatory frameworks to address market dynamics. Furthermore, state civil justice systems differ widely, particularly for auto insurance, and do not call for a "one-size-fits-all" approach. In at least one case, a public referendum led to the adoption of the state's current regulatory framework. State legislators should retain exclusive authority over this area of insurance regulation.

The NAIC's Roadmap for Regulatory Modernization
"Framework for a National System of State-Based Regulation"

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Subtitle A - Market Conduct Uniform Standards

NAIC Roadmap

The NAIC is implementing a more effective and efficient market regulatory system based upon the following five primary elements: (1) centralized data collection, (2) structured and uniform market analysis, (3) uniform examination procedures, (4) interstate collaboration and (5) a broader continuum of regulatory responses designed to address general business practice, with specific provisions for targeted examinations.

In 2004, the NAIC published the Market Analysis Handbook, with procedures for data collection and systematic market analysis of consumer complaint trends, financial data and other relevant market data that will lead to nationally-coordinated state market analysis programs. A critical component of state market analysis efforts is interstate collaboration on consumer problems of concern to multiple states through the NAIC's Market Analysis Working Group, which was formed in 2003. In 2002, the NAIC also adopted a comprehensive set of Uniform Examination Procedures, to which 42 states have certified compliance. Use of uniform procedures makes exams more efficient and plays a key role in enhancing collaborative efforts.

During the Fall National Meeting, the NAIC adopted a Market Surveillance Model Act, based on a model recently approved by NCOIL. In addition to providing statutory

direction for market analysis, the model will enumerate a broad continuum of regulatory responses to problems identified through market analysis. The model provides for targeted or "for cause" examinations to be conducted under uniform procedures by states based on identified patterns or practices that deviate significantly from industry norms or other indicators suggesting company practices or market conduct conditions that pose a potential risk to insurance consumers. The process includes review of prior examination reports to ensure that the identified issue has not already been adequately addressed.

One issue not addressed in the model act is routine oversight to determine whether companies have effective compliance systems in place. To accomplish this purpose, the NAIC is developing a nationally-coordinated system for periodic review of company compliance policies and procedures. This responsibility will be shared between the domestic regulator and other states having a significant premium volume or other special interest, and will include appropriate coordination with Best Practices Organizations as provided for in the NAIC's *Best Practices Organizations White Paper.*

The sharing of confidential information among state and federal financial regulators is critical to the effective coordination of state regulatory efforts. States generally have the necessary confidentiality procedures in place, but a federal statute that enables the exchange, maintenance, and use of confidential regulatory information among state and federal financial regulators, either directly or through entities such as NAIC that perform such functions on behalf of regulators, would create a uniform framework for achieving the appropriate coordination of state regulatory efforts.

As provided for in the NAIC's Uniform Examination Procedures, each state will devise a set of consistent and uniform enforcement guidelines based upon criteria, such as the willful or inadvertent nature of a violation.

A formal state accreditation process should be implemented to ensure uniform implementation of the five primary elements of market regulation.

Subtitle B – Company Licensing

NAIC Roadmap

The NAIC has created uniform applications and filing forms regarding a certificate of authority, i.e. ALERT, that are accepted in all U.S. jurisdictions. Electronic filing systems have also been created to facilitate these filings among state insurance departments.

Significant work is underway to streamline the licensing application form, adopt best practices, set standard licensing requirements and minimum review procedures to help ensure consistent and efficient reviews. These projects are expected to be completed in early 2005. The NAIC has adopted a plan to draft a model company licensing act.

Using NAIC's model company licensing act, states should codify ALERT system forms, including the Uniform Certificate of Authority (UCAA), related licensing/acceptance standards, and minimum review procedures by 2005. Using best practices guidance, states should leverage knowledge and experience of a company's domestic state, as well as current admission work done by NAIC Accredited states.

As an interim measure, states should continue to accept electronic filings under the ALERT System, including but not limited to the UCAA, company name changes, and adding/deleting lines of business. Deviations from ALERT filing requirements should be repealed or discontinued, as appropriate.

States should also: (1) Streamline the process for considering proposed mergers and acquisitions of domestic insurers involving multiple jurisdictions; (2) Establish Memorandum of Understanding based upon the NAIC lead-state framework to defer most inquiries and regulatory interaction to the designated lead state or states; and (3) Address regulatory requirements regarding reappointment of producers and policy/rate re-filings to streamline multiple state approvals.

Subtitle C – Producer Licensing

NAIC Roadmap

The NAIC supports the implementation of a centralized, electronic licensing system for producers through the following:

1. Implementing 100% licensing reciprocity among all jurisdictions, *provided*: (1) states have direct access to FBI fingerprint database similar to other regulators, and (2) states can share such information on a protected, confidential basis. An essential part of the background process will be the implementation of an electronic fingerprinting process;

2. Enacting/implementing NAIC Uniform Licensing Standards addressing: (1) licensing qualifications, (2) pre-licensing education, (3) producer licensing testing, (4) background checks, (5) application process, (6) appointment process, (7) continuing education requirements, and (8) limited line uniformity;

3. Implementing a uniform NAIC national producer licensing database;

4. Implementing electronic resident and non-resident licensing and licensing renewals; and

5. Streamlining the appointment process by implementing a registration system whereby insurers maintain a list of producers with whom they have a contractual relationship. Insurers will be required to electronically file this list on a quarterly

basis with the appropriate state insurance department, remit a fee in accordance with the current state appointment fee structure and immediately report any contractual relationships that are discontinued "for cause" because of a producer's inappropriate conduct.

Subtitle D – Life Insurance

NAIC Roadmap

State regulators believe effective regulatory modernization and uniformity for life insurance products can be achieved as follows:

1. State adoption of the Interstate Insurance Product Regulation Compact.

2. States will develop for implementation via the Compact high quality national insurance product standards to protect consumers.

3. States and the NAIC will work for continued enhancement and implementation of the SERFF system.

Subtitle E – Property/Casualty Commercial Lines

NAIC Roadmap

[Note: The NAIC recommends that subtitles E, F and J be combined into a single section that deals with property and casualty insurance products. There is too much overlap to address them separately, and to do so risks conflicting provisions of law.]

The NAIC supports the following actions related to speed to market for commercial lines property and casualty insurance products:

- Continued enhancement and implementation of the SERFF system to provide a single point for electronic filing of both commercial lines and personal lines insurance products with state regulators;

- For all commercial lines of business except title insurance, workers' compensation and medical malpractice, adoption of the NAIC Property and Casualty Commercial Rate and Policy Form Model Law (Condensed) or a similar regulatory framework that implements:

    - A Use and file competitive rating regulatory framework for rates and rating systems;
    - A File and use regulatory framework for policy forms with a 30 day waiting period; and

   - A provision that requires the commissioner to adopt reasonable regulations to provide that a particular state's policy form requirements shall apply only to insurance written for individual commercial risks that are primarily located in the state.

- Codification of a uniform national definition of "sophisticated/large commercial purchasers" borrowing from a similar definition contained in the NAIC white paper: *The Regulatory Re-engineering of Commercial Lines Insurance;*

- Development of filing review standards checklists that clearly spell out what is required by state law or regulation of insurers to submit a compliant filing;

- Development of a uniform filing transmittal document(s) to expedite the filing process where feasible; and

- Development of a common product filing nomenclature that allows both filers and reviewers to communicate effectively about the products being filed.

Subtitle F – Property/Casualty Personal Lines

<u>**NAIC Roadmap**</u>

[Note: The NAIC recommends that subtitles E, F and J be combined into a single section that deals with property and casualty insurance products. There is too much overlap to address them separately, and to do so risks conflicting provisions of law.]

Diversity to meet local market conditions is one of the strengths of state regulation. This is particularly true for homeowners and personal auto insurance coverage. The NAIC supports the following actions related to speed to market for personal lines property and casualty insurance products:

- Continued enhancement and implementation of the SERFF system to provide a single point for electronic filing of both commercial lines and personal lines insurance products with state regulators;

- Recognition that states face different circumstances regarding the regulatory framework for personal lines property and casualty insurance products and, while encouraging a movement toward various forms of competitive rating where feasible, allowing state legislatures to continue to determine the appropriate regulatory framework for personal lines;

- Development of filing review standards checklists that clearly spell out what is required by state law or regulation of insurers to submit a compliant filing;

- Development of a uniform filing transmittal document(s) to expedite the filing process where feasible; and

- Development of a common product filing nomenclature that allows both filers and reviewers to communicate effectively about the products being filed.

Subtitle G – Surplus Lines

NAIC Roadmap

The NAIC has long advocated an equitable premium tax allocation method on a countrywide basis and has done substantive work to support this position. Substantive discussions have also occurred with respect to defining sophisticated purchaser in the surplus lines market, however, concerns regarding the potential adverse impact to consumers outweighed the efficiencies that may be seen through an "automatic export" option.

Regarding allocation of taxes, states should codify the NAIC Model Regulation (Allocation of Surplus Lines and Independently Procured Insurance Premium Tax on Multi-State Risks), thereby requiring payment of premium tax to the states where the risk resides. Working through the NAIC, states should develop a dispute resolution mechanism or arbitration process where there is conflict between states. States should explore creation of an interstate compact or other mechanism to manage tax collection and reallocation to relevant states.

Regarding uniform licensing standards, states should mandate full implementation of the NAIC Producer Licensing Model Act to achieve reciprocal licensing standards. With regard to single point licensing, state participation in the NAIC national producer database should be mandated. Surplus lines producers should be added to state efforts to build upon licensing reciprocity by implementing a uniform, centralized electronic licensing system for individuals and business entities that sell, solicit or negotiate insurance.

States should codify the definition of "sophisticated/large commercial purchasers" by borrowing from a similar definition contained in the NAIC white paper: *The Regulatory Re-engineering of Commercial Lines Insurance*. States should also re-evaluate the NAIC Non-Admitted Insurance Model Act to accommodate recognition of sophisticated/large commercial purchasers.

Subtitle H - Reinsurance

NAIC Roadmap

Regarding extraterritorial application of state laws, states should move toward greater financial standardization through the NAIC Accreditation Program, including financial

reporting, credit for reinsurance, investment limitation and actuarial reserves. Through statute, regulation and practice, states should conform to the relevant NAIC Accreditation Standards as the interpretations of these Standards will be tightened to reduce deviations.

The NAIC has tabled discussion of a reduction in collateral requirements for unauthorized reinsurance. Informal meetings between commissioners and interested parties have been held in an attempt to arrive at a commercial solution.

(Also see Subtitle O – Receivership)

Subtitle I - Anti Fraud Network

NAIC Roadmap

State insurance regulators need Congress to enact federal legislation that would give them:

- Direct access to the FBI criminal history database in a manner similar to other regulators.
- Protection for confidential regulatory information shared among state and federal regulators.
- Liability immunity for NAIC using its database facilities as the means for state regulators to share confidential regulatory information.
- Coordination of regulatory information sharing with NASD.

As set forth in NAIC's May 19, 2004 letter to the Senate Finance Committee, Congress should enact a federal privilege and a statutory structure for coordination of investigations between federal agencies and the states. The privilege and structure should safeguard the confidentiality of communications among states and the federal government for the purpose of facilitating investigations into unauthorized insurance activity.

Subtitle J - Price Controls/Anti-Trust Exemption

NAIC Roadmap

Reaffirmation of the McCarran-Ferguson Act as the law of the land so that small and medium sized insurers are able to benefit from the limited anti-trust exemption, share information about loss costs, and have some hope of competing with larger insurers.

Subtitle K - Coordination and Enforcement of Insurance Policy

NAIC Roadmap

In preparing this document, the NAIC conducted a thorough review of modernization initiatives and pending reform proposals. As a result, the NAIC's roadmap represents a comprehensive proposal to address regulatory inefficiencies and promote workable national standards. The NAIC and states currently have the tools and mechanisms needed to implement these reforms, and believe that implementation and enforcement of these roadmap goals should be left to the states. However, where required as a matter of federal law, state insurance departments are committed to enforcing federal rules, whatever they may be.

State regulators are concerned that any organization established under federal law to interpret and oversee implementation of national regulatory standards would inevitably raise troublesome questions of "who's in charge" of state insurance regulation. Regulatory confusion in the dynamic insurance marketplace would breed harmful uncertainty that is counter-productive to achieving reforms. State regulators are also concerned that a federally-established body asserting federal powers to preempt state consumer protection laws could become controversial, as with the OCC's preemption of state predatory lending laws for banks. Congressional policy oversight is very helpful to state officials trying to resolve national issues, but federal administrative intrusion could be detrimental.

Subtitle L – Viaticals

NAIC Roadmap

The NAIC adopted a revised Viatical Settlements Model Act in 2001. Previously, viatical regulation only applied to sales of policies for people who were terminally or chronically ill. The model adopted in 2001 responded to changes in the marketplace and provided coverage for any sale of a life insurance policy for less than its expected death benefit. The model also included fraud provisions, advertising standards, and enhanced disclosures. Amendments to the Viatical Settlements Model Regulation (which accompanies the 2001 Model Act) were adopted in June 2004. The regulation includes licensing requirements and informational forms to be filed with the states.

The NAIC members feel strongly that each state should enact consumer protections for these policy owners, and believe a minimum standard of protection based on the NAIC Model Act and regulation is appropriate.

Subtitle M – Interstate Compact for Health Insurance Processes

NAIC Roadmap

To date, this issue has not been raised within the NAIC, nor has the basic concept been raised to the NAIC by health insurers. The NAIC is open to methods of achieving greater standardization, especially with respect to external reviews.

Subtitle N – Enhancing Financial Surveillance

NAIC Roadmap

While the state based solvency regulation system has proven to be generally effective and efficient, the States recognize that further "enhancements" will provide consumers with greater protection against financial loss. The following solvency monitoring enhancements are underway in the NAIC Financial Condition Committee.

1. Institute national practices regarding:

    - Periodic meetings between an insurer's executive management and financial regulators for the purposes of evaluating business strategies, financial projections, capital adequacy, etc.; Update: This work is under consideration through the risk assessment initiative and amendments to the NAIC model audit rule.

    - The evaluation of "corporate governance" matters and promoting best practices among non-public insurers; and Update: This work is underway through amendments to the NAIC model audit rule.

    - The use of confidential Administrative Supervision authority and best practices.

2. The NAIC Accounting Practices & Procedures Manual should become the national standard for operating insurers. Limit state permitted accounting practices to extraordinary circumstances. Implement interstate communication mechanism for state permitted accounting practices.

3. Institute standard financial surveillance practices regarding affiliated insurers, i.e. insurance groups.

    - Coordinate on-site examination scheduling, planning, and fieldwork on affiliated insurers to better allocate examination resources and strengthen examination results; Update: The Insurance Holding Company Working Group initiated correspondence with all states

urging development of plans to coordination examinations of their domestics affiliated in other states. The Working Group has also identified 12 insurance groups, which they plan to work with the states of domicile to help ensure coordination and to better understand the impediments.

- Standardize the exchange of information on affiliated insurers to help ensure a group-wide perspective; and

- Fully implement the NAIC lead-state surveillance framework to enhance financial monitoring activities and examination planning. Update: The Financial Examiners Handbook Technical Group is revising handbook language regarding requirements for coordination examination schedules and field work.

Subtitle O – Receivership

NAIC Roadmap

State regulators believe effective regulatory modernization and uniformity for insurer receiverships should be achieved as follows:

- Congress should amend the Federal Priority Statute so that insurer receiverships receive the same treatment allowed to federal bankruptcy estates.

- States should be required, under Part A of the NAIC Accreditation Program, to enact laws substantially similar to the updated Insurer Receivership Model Act currently being completed by the NAIC:

    - Rights and obligations of policyholders, reinsurers, state guaranty associations (SGAs) and other claimants and debtors to the estate,
    - Commissioners and supervising court's roles,
    - Priority of distribution,
    - Special deposits being deemed to be general assets, unless to benefit of SGA's (Create uniformity and consistency in the use of and access to special deposits),
    - Reciprocity and interstate cooperation,
    - Transparency and financial reporting (including to the Global Receivership Database),
    - Immunity and indemnification of receiver and others working for benefit of estate, and
    - Coordination and cooperation between the state guaranty system, receivers, and regulators.

There is already a requirement that states have "a scheme" for handling receiverships in the NAIC Financial Accreditation Program. Tightening this requirement is consistent with the concept that the accreditation process should cover more than solvency, including broader assurance that claims are paid to protect consumers and maintain confidence in the industry.

Testimony of
Edward J. Muhl
June 16, 2005

United States House of Representatives Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

`Mr. Chairman and members of the Committee

My name is Edward Muhl and I appreciate the opportunity to participate in today's hearing concerning the need for insurance regulatory reform.

My background spans nearly 40 years in the insurance industry serving in both the public and private sectors.

I was first appointed Insurance Commissioner of Maryland by the Democratic Administration of Governor Hughs and was reappointed by a second Democratic Administration of then Governor Shaffer. During my tenure as Maryland Commissioner I was elected by my peers to become Vice President then President of the National Association of Insurance Commissioners.

I have also had the opportunity to be appointed Superintendent of Insurance for the State of New York by the Republican Administration of Governor Pataki and have served in the private sector with insurance companies and accounting and consulting firms.

Over these forty years I have experienced regulation from the perspective of a company official, a regulator, a consultant and as a consumer of these industry services. Mr. Chairman, there

is an enormous redundancy of costs and procedures in the present system of regulation which serves only to add to the premiums paid by the consumer and to raise the level of frustration in trying to deal with the complexity of the process. I am very pleased that this Committee is taking the initiative to look at the basic processes that affect all of us and hopefully you will conclude that the present system is in need of some change.

Having said that, I believe that state regulation of the business of insurance remains better positioned to respond to unique issues of both consumers and companies in certain geographic areas. Unfortunately the difficulty remains in the inability of the present system to attain the uniformity necessary to eliminate the redundancy of these costs. There are simply too many independent and diverse focal points of authority in the states and US territories to be able to gain consensus. The result is a costly and redundant system.

I started in regulation in 1982 and since that time I have seen efforts of individual regulators and the NAIC to try to simplify the process, gain uniformity and eliminate the unnecessary costs in the system. Unfortunately there has been but only some evidence where these efforts have proven successful over 20 plus years.

When I became the New York Superintendent in the mid 90's, my experience was that the New York Department was one of the strongest departments in the US and certainly one of the slowest in responding to time line issues. We conducted a review of all the 160 plus regulations to determine if any were in need to be updated or were obsolete and no longer useful to effective regulation to protect consumer interests and to advance the interests of the industry. Some of these regulations

were in effect and unchanged for 100 years but were still strictly enforced by the department staff despite the costs and inefficiencies. The review of these regulations resulted in the elimination of 50 outdated ones and the remainder were updated which benefited consumers, insurers and served to increase the effectiveness of the department.

The career staff in the Insurance Departments prove every day to be extraordinary and dedicated individuals who take their task of regulating the insurance industry quite seriously and are, for the most part, up to the task. Much of the oversight processes are handed down generation to generation with little or no time or effort available to look beyond the daily work because of the volume. The entire system needs to be looked at, stirred and find a better way to deal with all the important issues.

I would just add one point on rating.
I served as a regulator at a time when the rating law of the State was Prior Approval, then changed by the legislature to Competitive Rating and finally in New York with Flex Rating. Going from a Prior Approval to an Open Competition forum proved to me that Competition is an effective regulator of rates which allowed me to make better use of my limited staff resources and putting them to use in the area of Market Conduct Examinations and other sensitive areas. It was not an easy transition but once the competitive forces came in to play and the interests of the consumers and the industry were in balance, the system worked very well. I would urge a close review of the benefits of such a rating mechanism.

I have been privileged to have been asked by the Committee Chairman and staff to review the many titles of the SMART draft and to offer comment and my views as a former regulator. I applaud the Committee's efforts in looking into the

current system and taking the initiative in determining needed changes. I look forward to offering additional support in your review process and wish to thank the Chairman and staff in giving me the opportunity to voice opinions.

Edward J. Muhl

TESTIMONY OF MIKE PICKENS BEFORE THE CAPITAL MARKETS SUBCOMMITTEE OF THE HOUSE FINANCIAL SERVICES COMMITTEE

THURSDAY, JUNE 16, 2005

ROOM 2128 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC

Mr. Chairman, Ranking Member and Committee Members:

Thank you for this opportunity to once again testify on the important issue of insurance regulatory reform. I commend the Chairman and all the Committee members on your continued interest in, and enlightened, progressive work on, this issue -- one that is vital to all of us insurance consumers, the financial services marketplace and the United States economy.

During my years as an officer and 2003 president of the National Association of Insurance Commissioners ("NAIC"), my position on this issue has been, and remains, consistent: In order to better protect all us consumers and to survive, the state regulatory system must become more effective, more efficient, less costly and less burdensome. It is consumers, not the insurance industry, who bear the burdens and pay the costs when regulation is ineffective and inefficient. This issue of regulatory modernization is about consumer protection, competition, better products and better prices.

When I was NAIC president in 2003, our membership -- which included some twenty-two (22) brand new chief regulators -- made it clear they wanted the NAIC to have a strong, credible voice in Washington, DC. That is why we created a Governmental Affairs Committee, the state-based ASSURE initiative, and hired Washington insiders to help educate Congress about our issues.

At that time, as now, state regulators were faced with essentially three (3) options:

(1) Develop our own modernization plan and get it passed in each state, one state at a time;

(2) Engage the House Financial Services Committee and provide technical expertise and input on the "federal tools"/SMART approach, where the "threat" of preemption could be used as both a "carrot and a stick" to expedite necessary and appropriate state-based reforms; OR

(3) Do nothing and confront the very real possibility of the creation a so-called optional federal charter ("OFC"), which would result in total preemption and the total loss of state authority.

Wisely, in 2003 our membership chose options one (1) and (2). We met in Austin, Texas and pounded-out our plan, "A REINFORCED COMMITMENT: INSURANCE REGULATORY MODERNIZATION ACTION PLAN," and we began the hard work of implementing it in each state, one state at a time. (Please SEE my testimony of Wednesday, November 23, 2003, given before this Subcommittee.)

In addition, as early as the year 2000, we began working to develop a relationship based on credibility, trust and technical expertise with our Members of Congress.

It is in this spirit of consumer protection, reform, credibility and trust that I began working with this Committee when I became a NAIC officer. It is in this spirit that I and others were asked earlier this year to work with Committee staff in providing objective, expert input on the SMART initiative. As always, I appreciate the Committee giving me the opportunity to continue the good work my NAIC colleagues and I started some five (5) years ago.

Let's give credit where credit is due: State insurance regulators, working through the NAIC, have made some impressive progress in implementing the 2003 ACTION PLAN. They have worked hard and made significant progress in bringing about uniformity of laws and administrative processes in the areas of producer and company licensing reform, making better products available to consumers as quickly as possible, and working to protect consumers from fraud in viatical sales and on military bases. Where appropriate, state regulators have provided their expertise to Congress on Sarbanes-Oxley, the Terrorism Risk Insurance Act ("TRIA"), the USAPatriot Act; asbestos, civil justice and medical malpractice reform and international insurance issues, among a host of others.

Still, as hard as they are working, state insurance regulators are limited in how much they themselves can do to pass needed laws and implement long-overdue reforms. State regulators must have the help and support of their governors and legislators to implement the reforms. I was fortunate: For my eight (8) years in office I had the support of my governor and a majority of Arkansas legislators.

However, in far too many states, when budgets get tight state regulators see their consumer protection trust funds raided, their programs frozen or cut, their legislation caught up in the politics of the moment, and some of their most experienced personnel leaving state government for the perceived "greener pastures" of the private sector. Reforms get stalled, languish, are eventually forgotten. This is not in the best interests of our consumers and markets.

Regardless of how hard they work, state regulators can not do the job alone. Even today, it is well documented that the state-based system continues to be burdened by a lack of uniformity in both regulatory philosophy and laws, and by ineffective and duplicative oversight, and insufficient coordination in some areas. There remain a handful of states where, for a variety of local political and other reasons, reforms may be difficult or even impossible to pass. State regulators, working through the NAIC, need a "big stick," they

need your help and support if they are to be able to achieve the reform initiatives they already have unanimously agreed upon in their 2003 ACTION PLAN.

Even if state regulators can convince lawmakers to implement their promised reforms in a majority of the states, can they do so in the largest markets, where the greatest numbers of consumers stand to benefit from them? And how much longer will it take the states to implement the promised reforms? Five (5) years, ten (10) years, fifteen (15) years? This is a legitimate question: Can the states implement the promised reforms, and how long will it take?

I am a strong supporter of state insurance regulation. That is why I have been willing to engage and work with the Committee on the SMART approach. Is the SMART approach perfect? Of course, it is not. For one thing, I don't like the idea of creating a federal agency to oversee regulatory reforms and to act as a go-between for the federal government and state regulators. We have plenty of federal agencies already. This entity also could prove to be the precursor to a federal regulatory agency.

I also am opposed to federal preemption of state insurance laws. But significantly, preemption NEED NEVER OCCUR under the SMART proposal.

SMART does not use "preemption" -- but rather the "THREAT of preemption" -- to help state regulators overcome the political and other obstacles that exist in some states so that they can in fact implement, enforce and continue to regulate their promised reforms. Under the SMART, or "federal tools" approach, all the states need to do in order to avoid any preemption is to convince their state law and policymakers to implement the reforms they already have agreed upon and promised to deliver. Of course, this is easier said than done. And this just may be the reason something akin to the SMART idea may work to help my former regulatory colleagues keep their commitments sooner rather than later.

The Gramm-Leach-Bliley Act ("GLBA") required states to develop and implement producer licensing reforms within a specified time period or to lose their authority to a newly-created Orwellian-sounding federal agency, the National Association of Registered Agents and Brokers ("NARAB"). How did the states respond to this "threat" of preemption? They set a NAIC speed record in creating a model law and getting it passed and implemented in more than the required number of states, including some of the largest markets in the country.

Similarly, following a rash of high-profile insolvencies in the late 1980's and 1990's that seemed to take everyone by surprise and created both consumer angst and market instability, United States Representative Dingell of Michigan encouraged state regulators to reform or to be eaten alive by the federal government. State regulators responded affirmatively, as they always do to such encouragement, by creating the NAIC Financial Solvency Accreditation Program. Though not perfect, this program has proved to be a resounding success and has resulted in better financial solvency regulation and consumer protection.

It is said that the greatest champions respond to the greatest challenges; they rise to the occasion; they work best and deliver most when the stakes are the highest.

In my book, state insurance regulators are great champions who will, as they have always done, respond courageously and prove to be victorious when the chips are down.

But they need your support and your help. SMART just may be the tool state regulators need to help expedite the promised reforms in the states. I look forward to working with you and my friends and former colleagues at the NAIC, to make the SMART proposal the best, most effective, most user-friendly tool to meet our common objective of better consumer protection and more consumer choice through regulatory reform.

Will SMART work? I don't know, but for my money it beats the heck out of the so-called optional federal charter approach, and nobody has come forward with a better idea. Perhaps it is worth a try.

Thank you again for the opportunity to work with you on this initiative. I look forward to answering your questions.

CURRICULUM VITAE OF MIKE PICKENS

James Michael ("Mike") Pickens is a partner in the Little Rock, Arkansas law firm of Friday, Eldredge and Clark. Mr. Pickens' practice includes insurance regulatory work, insurance and workers' compensation litigation and family law.

Governor Mike Huckabee appointed Mr. Pickens to a four-year term as Arkansas Insurance Commissioner effective 15 January 1997. Governor Huckabee reappointed him to a second four-year term as insurance commissioner effective 15 January 2001.

Prior to assuming the insurance commissioner's post Mr. Pickens was a partner at the Friday Firm, where he practiced in the area of insurance defense litigation, representing policyholders in personal injury and workers' compensation litigation.

Mr. Pickens is a 1980 I graduate of Pine Bluff High School in Pine Bluff, Arkansas. He graduated from the University of Mississippi ("Ole Miss") in 1984 with a B.A. in English, a minor in psychology and an emphasis in a pre-medicine curriculum.

Mr. Pickens graduated from the University of Arkansas at Little Rock School of Law with a Juris Doctorate degree. While in law school he was an Associate Survey Editor for the UALR LAW JOURNAL. His casenote was entitled, "Administrative Law -- Rescuing Creditor Claims From the 'Black Hole,'" Coit Independence Joint Venture v. Federal Savings and Loan Insurance Corporation, 12:2 UALR Law Journal 441 (1989-90).

Mr. Pickens is licensed to practice law in all Arkansas state and federal courts, the United States Court of Appeals for the Eighth Circuit, and the United States Supreme Court. He has been a member of the Pulaski County, Arkansas and American Bar Associations, as well as a member of the Lawyers for Literacy and International Law Committees of the Arkansas Bar Association. He has served performing pro bono legal work through the Volunteer Organization for Central Arkansas Legal Services ("VOCALS"), a joint venture of the Pulaski County, Arkansas Bar Association and Central Arkansas Legal Services, Inc.

While serving as Arkansas insurance commissioner, Mr. Pickens represented Arkansas as a member of the National Association of Insurance Commissioners ("NAIC"). The NAIC is composed of the chief insurance regulatory officials from all fifty states, the District of Columbia and five United States territories. (Please SEE www.naic.org for more information about the NAIC.)

In December of 2000, Mr. Pickens was elected secretary-treasurer and in December 2001 vice-president of the NAIC. In December 2002, Mr. Pickens was elected president of the NAIC. He served as NAIC president from December 2002 through December 2003. In 2004, Mr. Pickens served as NAIC immediate past president. While NAIC president, Mr. Pickens authored an article for the Journal of Insurance Regulation entitled "The NAIC's 2003 Agenda Modernizing State Insurance Regulation: A Legacy of Consistency, Efficiency and Trust," 21:3 Journal of Insurance Regulation 117 (2003).

While serving as a NAIC officer, Mr. Pickens participated in various committees, subcommittees, task forces and working groups, as well as a number of leadership positions, including the following: chair of the Executive Committee; chair of the Internal Administration ("EX1") Subcommittee; chair of the International Insurance Relations (H) Committee; chair of the Antifraud (D) Task Force; chair of the Ad Hoc Task Force on Patriot Act Compliance; and vice chair of the Information Systems (I) Task Force, among others.

Arkansas played a leading role in the NAIC's efforts to defend and modernize state insurance regulation in the wake of the passage of the Gramm-Leach-Bliley Act ("GLBA") in November of 1999. Arkansas was one of the first states to allow single-point-of-filing electronic submission and review of policy forms via the NAIC's System for Electronic Rate and Form Filing ("SERFF") and Coordinated Advertising Rate and Form Review Authority ("CARFRA") initiatives. Arkansas played a leadership role in the development of the NAIC's 2000 Statement of Intent, 2003 Statement of Intent, and the 2004 Regulatory Roadmap which Congress considered in drafting the State Modernization and Regulatory Trasparency ("SMART") Act. Arkansas also led the NAIC's Alliance for Sound State Uniform Regulatory Efficiency ("ASSURE") initiative, creating a coalition of the supporters of state insurance

regulation to work to modernize state regulation where appropriate and necessary, and to work against the creation of a federal regulator for insurance.

As NAIC president, Mr. Pickens worked to strengthen the relationship of the NAIC with the National Conference of State Legislatures ("NCSL") and the National Conference of Insurance Legislators ("NCOIL"). He led the effort to establish the NAIC Governmental Affairs Committee and to make the NAIC's Washington, D.C. office more efficient and effective. Pickens led the NAIC's adoption of A REINFORCED COMMITMENT: INSURANCE REGULATORY MODERNIZATION ACTION PLAN.

In September of 2003, Pickens led a delegation of United States insurance regulators to China for meetings with the China Insurance Regulatory Commission ("CIRC"). These meetings culminated in the December 2003 signing of an agreement between the NAIC and CIRC that established, among other things, the Chinese Intern Training Program. (The first training took place in the fall of 2004.) Pickens also signed a Memorandum of Understanding ("MOU") between the NAIC and Vietnamese regulators. Pickens initiated discussions with Hong Kong insurance regulators concerning the signing on an MOU, and worked to strengthen the relationship between Latin American and United States regulators.

In his capacity as Arkansas insurance commissioner, Mr. Pickens was a member of various insurance-related committees throughout state government, including the State Employee Benefits Board and the Governmental Bonding Board.

During his eight-year tenure as insurance commissioner, the Insurance Department's leadership team reorganized the Department, increased the use of technology, and improved consumer and constituent services in every area From 1997 through 2004, our Consumer Services Division recovered over $ 8 Million in claims payments for Arkansas insurance consumers. The Arkansas Insurance Department won two rounds of NAIC accreditation for its insurer solvency monitoring capabilities and work. The Department won the NAIC's Technology of the Year Award for two consecutive years, 1998 and 1999, first for its innovative producer licensing software, and next for being the first state in the country to implement all of the NAIC's regulation 2000 technology initiatives. In addition, the Department passed over 100 consumer protection laws, including modernizing the entire ARKANSAS INSURANCE CODE. The Department conducted a number of high profile, successful fraud operations. The Department repealed over 100 obsolete regulations, directives and bulletins, and cut its regulatory fees by approximately $800,000. From its Trust Fund surplus, the Department was able to provide additional funds to the state's high risk health insurance plan, the Comprehensive Health Insurance Plan ("CHIP"), and to Arkansas's rural firefighters.

In 2000, BEST'S REVIEW, a publication of the A.M. Best Company, one of the country's oldest and most highly respected insurer rating organizations, recognized the Arkansas Insurance Department as one of the most progressive state regulatory agencies in the country.

From April through June of 2004, Mr. Pickens worked as a senior insurance advisor for the United States Agency for International Development's ("USAID") Iraq Economic Governance Project in Baghdad, Iraq. Mr. Pickens' work on the project included, among other things, drafting a proposed new insurance law, regulations and reporting forms for Iraq based on international regulatory "best practices," as well as providing training concerning the new legal requirements and reporting forms to the Iraqi regulator and insurers. The proposed new law was endorsed by the Iraqi Minister of Finance prior to the transfer of from the Coalition Provisional Authority to the Iraqi Interim Government in the summer of 2004, and enacted by the Iraqi government in March of 2005.

In October 2004, then-United States Secretary of Agriculture Ann Veneman appointed Mr. Pickens to the board of the Federal Crop Insurance Corporation, as the insurance-regulatory member.

Mr. Pickens resides in Little Rock with his wife, Melissa, who is a high school science teacher and volleyball coach; his 12-year old daughter, Mary Catherine, 9-year old son, Rob, and their two Boston terriers, Zero and Buster. Mr. Pickens and his family are active members of the Pleasant Valley Church of Christ.

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STATEMENT OF GREGORY V. SERIO
MANAGING DIRECTOR,
PARK STRATEGIES, LLC

FORMER SUPERINTENDENT OF INSURANCE
STATE OF NEW YORK

BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES

THURSDAY, JUNE 16, 2005

WASHINGTON, DC

Mr. Chairman, ranking member and members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, thank you for asking me to appear before you to discuss the issue of insurance regulatory modernization and to comment on the efforts behind the SMART insurance reform. My name is Gregory V. Serio, managing director of Park Strategies, LLC, a strategic planning and management consulting firm in New York City, and I served as superintendent of insurance for the State of New York from 2001 to 2005.

Modernizing insurance regulation is actually a multi-faceted undertaking, comprising the dual tasks of updating both insurance statutory standards and insurance regulatory standards, in addition to monitoring any case law development that also serves a role in the evolutionary process of the law. Insurance regulators and legislators both saw the need for modernization as a matter of culture rather than as a static event, and their representative groups, namely the National Association of Insurance Commissioners (NAIC), National Conference of State Legislatures (NCSL) and the National Conference of Insurance Legislators (NCOIL) undertook a series of initiatives over the past five years to help construct a coordinated approach to insurance reform.

Key to that effort was the creation of a productive dialogue with key members and committees in Congress—this Subcommittee and its members

chief among them—to forge consensus on the key areas needing reform and on the best way to achieve these mutually-desirable goals.

The underlying common thread among all players, federal and state, in the early stages of the insurance reform dialogue was to avoid replication of the awkward dynamics of the discussions leading up to the passage of the Gramm-Leach-Bliley (GLB) legislation, where it is universally agreed the state insurance legislative and regulatory community did not have an effective voice in that process. "Having a seat at the table" and, more importantly, a voice that would and could be heard, was a critical condition precedent to engaging in any discussions on insurance modernization; equally well understood, however, was that seats at the table had to be earned by a willingness to compromise for the larger good of meaningful insurance reform.

The quality of the insurance reform being considered in these early discussions was measured by the same standard that is still being applied to current deliberations: can adequate uniformity in laws and regulations be achieved so as to be able to justify the continued support of the state-based system of regulation. Uniformity was and continues to be the gold standard for measuring effective modernization of state insurance regulation, but it also is proving to be far more elusive a goal than many thought. Perhaps it is because some did not realize that the quest for uniformity within a state-based system would still require some states to shed some individual autonomy, perhaps it is because some erroneously thought that uniformity would mean deregulation when it clearly does not, or perhaps it is because at the end of the day there may not be the same level of commitment to modernization of insurance policy and practice as many had originally thought.

The ongoing dialogue between public policy makers and regulators must continue to focus on the issue of uniformity if we are to assure that laws keep pace with the rapidly changing dynamics of the domestic and international insurance markets. Uniformity is also a crucial element to the public's better understanding of insurance, how it works and what they can and should expect from it. In the mobile society we live in today, the public should have reasonable expectations that the rules applied in one jurisdiction are reasonably similar to those in another jurisdiction, and that they are not forsaking adequate insurance regulatory protection simply because they have moved from point A to point B. Uniformity also allows regulators to more

smoothly and effectively join in joint regulatory actions, with less concern for nuances from one state to another that could undermine or complicate a multistate market conduct or financial examination. Indeed, uniformity would seemingly be the regulators' friend, allowing them to focus on examination, enforcement and consumer protection activities, and the enemy of the unscrupulous market player who arbitrages the vast variety in the bodies of law and regulatory environments by opportunizing the inconsistency in state laws for mischievous purposes.

It would be unfortunate if the efforts at regulatory modernization were hampered or stalled because of the inability to achieve consensus on uniformity of standards in certain critical areas. Inability to gain agreement on uniformity would also undermine all that which has occurred up to this point in the name of uniformity. The NAIC's accreditation program, the many model laws and regulations promulgated by the NAIC and NCOIL, the successful implementation of the GLB functional regulation of financial holding companies by state and federal authorities, and now the SMART legislative model put forward by the House Financial Services Committee are all examples of efforts taken individually and jointly by these entities to pursue greater uniformity in the statutory basis of state insurance regulation. Most notably, the insurance interstate compact, now passed by more than 15 states, a concept embraced by the NAIC, first championed by the NCOIL so many years ago and included within the SMART draft, provides the structural framework for assuring uniformity across the spectrum of issues over the long term.

To promote the concept of uniformity as the keystone to insurance regulatory modernization, the NAIC issued last year a "roadmap" (Modernizing the Insurance Regulatory Structure: The NAIC Framework for a National System of State-based Regulation) for regulatory improvement to serve as complementary document to Chairman Oxley's vision for improvement of the state-based system of insurance regulation, as he presented it to the NAIC at the Spring 2004 national meeting. Identifying points of consensus and earmarking points of disagreement allowed us all participating in the working dialogue to find areas of agreement quickly on the so-called "low-hanging fruit" and to concentrate our efforts on the more significant questions before us. Indeed, the NAIC, in its vision statement, expanded the perspective of the Chairman's view—at his invitation--by including provisions for greater financial surveillance and holding company

oversight, two issues that have taken on even greater importance given the events of the past several months.

The two roadmaps were and are not competing documents; they were and are the basis upon which consensus on national standards can be built. The SMART bill as currently drafted is a worthy progeny of the original roadmap initiatives. It contains many provisions that were originally in the NAIC vision statement. The SMART dialogue does not presume the SMART draft to be the final word on any issue, as serious discussion needs to be had on bellwhether issues like rate regulation, the national partnership and the preemption powers. And state insurance regulators need to know that they are gaining the tools they need to effectively regulate the business of insurance in a new world order.

From the mutually constructive beginnings of these discussions and the valuable work products that have come from the open dialogue that has been the hallmark of this policy-making undertaking, though, there has been some erosion in the trust and confidence of all players with respect to the joint commitment to see this process through to what was once the articulated goal of all involved: "to modernize state insurance regulation in a manner that benefits both insurance consumers and industry participants" (from the NAIC roadmap document). Consequently, those who would prefer a more radical reform of insurance regulation (or those who envision a weakening of insurance regulation in the name of reform) now see new life being breathed into their efforts, largely on the strength of the notion that those who prefer to improve state-based regulation are a camp divided.

Uniformity of laws and regulation will allow the state-based system of regulation to become more effective and efficient in its enforcement of the law, as noted above. It will also allow the industry's own efforts to improve regulatory compliance, internal controls and corporate governance to be more effective. The self-regulatory mechanism model now in place in the securities market and embodied effectively in the National Association of Securities Dealers, Inc. (NASD) can be greatly replicated and enhanced in the insurance sector through greater uniformity of laws and transparency in regulatory processes. Organizations like the Insurance Marketplace Standards Association (IMSA)—once challenged by regulators to provide greater disclosure of information and transparency of process--has shown that self-regulatory bodies can thrive in insurance, and even achieve regulatory efficiencies for its companies, as seen in recent regulatory

announcements in New York, Texas and Massachussetts and by the NAIC in an amendment to its market examiner's handbook accepting IMSA work products and analyses in the planning and execution of market conduct examinations. Greater uniformity in laws and regulations can make self-regulatory and best practices organizations like IMSA even more effective at promoting good market conduct by insurers and better at integrating their activities into the standard regulatory process.

Uniformity, where applied, has paid dividends. In producer licensing, the flow of information between states has given the United States, for the first time, a real national system of agent licensing regulation. At the same time, it has also made it infinitely easier for agents to expand beyond the borders of their own states, creating a far more dynamic insurance marketplace. The leveraging of technology by state insurance departments in this new regulatory paradigm has made life for agents and regulators even better still. In product development, as seen in the concentration of effort on life products in the interstate compact initiative and in the speed to market advancements made in New York, Ohio and elsewhere, real benefits from uniformity of process, if not policy, are being realized.

Uniformity of laws, regulation and process has been the stated goal of the NAIC since its origin over 130 years ago. It has been true to the quest, and has made particularly impressive strides over the past five years, from the Statement of Intent to the Reinforced Commitment to Modernization to the roadmap to the passage of the interstate compact legislation, producer licensing initiative and other uniform standards. Its members also know that modernization of regulation and the uniformity upon which it is based is very much a process and not an event. Changes will be necessary from time to time, and the ebb and flow of negotiation and compromise will always benefit all parties in the long run even if it seems that one side is giving more than the other at any given moment. Maintaining the long-term perspective of preserving the state-based system of insurance regulation—not simply because it has been the historical method of regulation but because it is the system best-suited to meet the demands of a changing world—will be all the motivation that regulators need to understand and embrace the give-and-take of the SMART deliberative process. The Congress will also understand that it stands in the best position when it works with the states in a cooperative venture to improve the state-based system of regulation rather than substituting a new federal government

regulatory body for a regulatory system that already works quite well and is poised to be even better with greater uniformity of policy and process.

Thank you for the opportunity to appear before you today, and I look forward to answering any questions.

Testimony of Nathaniel S. Shapo

House Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Honorable Richard H. Baker, Chairman

June 16, 2005

COMPETITION AND EFFECTIVE REGULATION OF INSURANCE RATES

Introduction

Mr. Chairman and members of the committee, thank you for the opportunity to appear before you again as you conduct your important oversight work.

My name is Nat Shapo. I am a partner at Sonnenschein Nath & Rosenthal LLP and I am a Lecturer in Law at the University of Chicago Law School.

I had the privilege of serving as the Illinois Director of Insurance from January 1999 to January 2003. During that time, I was elected four times to the National Association of Insurance Commissioners Executive Committee, including twice as a national officer.

I have previously served as a witness in front of this committee regarding government price controls, which is the topic of my testimony today. During my time as a regulator and since, I have firmly believed, and argued, that competition, not government, is the most effective regulator of personal lines automobile and homeowners insurance rates.

The solvency regulation, market conduct oversight, form review, and responses to consumer complaints carried out by the professional and dedicated members of state insurance departments throughout the United States are all necessary and appropriate functions of government. Without this affirmative state oversight, the insurance market would be subject to a race to the bottom and policyholders would be in substantial peril.

But consumers comparison shop based on price every day for purchases large and small. They are perfectly able to use the law of supply and demand to protect themselves regarding the proper amount they should be charged for a good or service. Competition is the most aggressive regulator of prices that the economy has ever known.

I believe it is entirely appropriate for Congress, in its Constitutional role as the regulator of interstate commerce, to consider updating its laws to properly reflect the needs of consumers in today's insurance marketplace. Congress's previous policy choice in the McCarran-Ferguson Act to encourage the states to engage in anti-competitive regulatory practices in order to support solvency regulation has been made obsolete by advances in sophisticated financial regulation and by the development of a thriving competitive marketplace for personal lines insurance.

History, experience, common sense, and basic economics all suggest that Congressional action to install a regulatory system relying on the law of supply and demand rather than price controls is an appropriate oversight measure commensurate with consumer need in today's highly competitive personal lines insurance marketplace. Since Congress was largely responsible for today's price controls, it can preempt state laws in this area of oversight without disturbing the current balance of federalism or jeopardizing the primacy of state regulation in any way.

A Peculiar, Unique, and Upside Down World

At this point I'd like to ask you to consider the following hypothetical. A committee or subcommittee of Congress has oversight of an industry through its Constitutional authority over interstate commerce.

Suppose that industry has the following characteristics. Hundreds of sellers offer the product in question to consumers who are fully able to comparison shop for price. The market is not concentrated or monopolistic. In fact, sellers aggressively and directly claim that they can beat their competitors' prices. Advertising is ubiquitous: television, radio, print, internet, billboards, direct mail, etc. The product is accessible to consumers and can be purchased through a variety of means: over the phone, in person, or over the internet; directly from the company or through a trained agent. Comparison of price is feasible since the product sold is relatively common and standardized.

If you would further suppose that I came and argued to the relevant oversight committee that the product in question should be subject to government price controls; that the form of those price controls should require sellers to submit their proposed prices, in advance, to a regulatory agency with substantial documentation; and that the agency might perform a time-consuming review of these submissions before deciding whether the seller's prices could be used in commerce.

I expect that if I provided such testimony, I would be given a lecture about free markets by members from both parties, and told that I had a complete misunderstanding of basic, consensus ideas about American public policy. I also suspect that I would never be invited back and that whatever staff person was found to be responsible for suggesting or approving my participation would soon be joining me out in the street.

For some reason, however, because the product in question is insurance, when I express the opposite view -- that government price controls in a competitive market should be done away with -- this is not treated as a thoroughly self-evident, non-controversial premise, but is rather seen as a suggestion that will surely face an enormous battle to be codified.

The History of Price Controls in Insurance: Rate Regulation as a Solvency Tool

What makes insurance different than any other product? Why is it not obvious that price levels in a competitive marketplace should be regulated by supply and demand, as they are throughout the economy without exception? An unusual history explains how we got here. But, in studying

that history, it is clear that there is no reasonable rationale for the common practice of seeking to ensure affordability and availability of auto and home insurance through price controls.

Rate regulation in insurance has its roots as a solvency tool. In the 1800s and early 1900s, repeated catastrophic events in the primary line of coverage used by average Americans -- fire insurance -- were the catalyst for an unusual regulatory response. All too frequently, urban conflagrations, such as the great Chicago fire and the San Francisco earthquake and fire, led to mass carrier insolvencies.

Policymakers studying the problem found that competition led to harmful results in the insurance business. Both underwriting and solvency practices were unsophisticated and crude. Reserving standards were terribly inadequate. Cutthroat price wars and the struggle for premium only exacerbated the problem. So, in the early 1900s, just as trust-busting was becoming the order of the day, and competition was embraced as the most effective way to ensure affordability of product and protect consumers, insurance regulation began pursuing an opposite course, as legislators sought to restrict competition in insurance rate-making.

In order to avoid under-pricing and the disastrous insolvencies which followed, states passed laws which encouraged carriers to collude with each other and even make rates in concert. Because government was encouraging monopolistic behavior, it had to regulate the resulting rates to prevent the abuses which can occur when there is no competition. Rate regulation also allowed government to ensure that collusion was producing the desired result of prices which were adequate to support solvency.

It is essential to understand that rate regulation was a means to the end of keeping prices up in order to support carrier solvency. The purpose of rate regulation was not to ensure affordability and availability of insurance coverage for consumers.

The underlying premise that justified this entire system was that rate regulation was appropriate in a non-competitive market. The Supreme Court, in narrowly upholding an early state price control law as constitutional, explicitly referenced the lack of competition in the marketplace as a justification for the statute in question.

> We may venture to observe that the price of insurance is not fixed over the counters of the companies by what Adam Smith calls the higgling of the market, but formed in the councils of the underwriters, promulgated in schedules of practically controlling constancy which the applicant for insurance is powerless to oppose and which, therefore, has led to the assertion that the business of insurance is of monopolistic character and that "it is illusory to speak of a liberty of contract."

German Alliance Insurance Co. v. Lewis, 223 U.S. 389, 416-17 (1914).

Thus, the intellectual and legal underpinnings of government rate regulation of the business of insurance are rooted in a market that was recognized as uncompetitive and "of monopolistic character." These traits were essential to justifying the rationale for price controls.

The McCarran-Ferguson Act: Disabling Competition Was the Choice in 1945

The practice of rate regulation was somewhat common but far from uniform in the states by 1944, when the Supreme Court declared in the Southeastern Underwriters case that insurance is interstate commerce. This case dealt with an indictment for violations of the Sherman Act, which a cartel of carriers had brazenly violated because they believed that this federal law did not apply to insurance, since the business had previously been held by the Supreme Court not to be interstate commerce.

In the Southeastern Underwriters case, the Supreme Court specifically recognized that opponents of the decision had forecast doom for insurance carriers and consumers if competition was unleashed on the industry. But the Court held that competition was a fundamental tenet of regulation of commerce under American public policy, which "make[s] of ours, so far as Congress could under our dual system, a competitive business economy." U.S. v. South-Eastern Underwriters Assn., 322 U.S. 533, 559 (1944). The Court acknowledged "opinions expressed by various persons that unrestricted competition in insurance results in financial chaos and public injury," but concluded that only a conscious choice by Congress could exempt an industry from such regulation: "Whether competition is a good thing for the insurance business is not for us to consider." Id. at 561.

The next year, in response to the Supreme Court, Congress did decide that competition is not "a good thing for the insurance business." The landmark McCarran-Ferguson Act of 1945 essentially established a national policy favoring price controls for the industry. McCarran-Ferguson and the subsequent "All Industry" bills, which quickly and broadly passed in the states based on NAIC models, were a swift reaction to, and codification of, the prevalent argument at the time: that competition in the insurance business was bad for consumers and thus must be disabled.

McCarran-Ferguson was intended to prod the states to replace the inconsistent patchwork of rate oversight with thorough price controls in all states. As Senator O'Mahoney, a conferee on the final bill, explained:

> The conference report would give to the States, to the Congress, and to industry the opportunity to adjust the laws and insurance practices as to bring clarity into the whole situation, in the public interest. It is an invitation to the States to legislate in good faith. It is an invitation to the insurance industry to operate in good faith in the halls of the various State legislatures, and of Congress.

91 Cong. Rec. 1486-87 (Feb. 27, 1945).

The purpose of these rate regulatory laws was to serve as a crude means of solvency regulation, not a method of ensuring availability and affordability. It was then (and of course it remains) bedrock American public policy that competition, not government micro-management, is the best way of ensuring availability and affordability and protecting consumers.

At the time, stifling competition, though a highly unorthodox approach to regulation of commerce, was appropriate consumer protection due to the unique concerns about under-pricing and bankruptcy in the insurance business. There is no more important consumer protection than ensuring that policyholders' claims will be paid by regulating carrier solvency. (This was

particularly true in an era when there was no guaranty fund coverage.) Price controls were thus used for their proper purpose: preventing abuses when government sanctions monopolistic practices.

Since government had decided that price wars were harmful to consumers, and had intentionally disabled competition in the insurance marketplace, it needed to institute rate regulation. It was never suggested, however, that price controls were appropriate for a competitive industry, or that price controls are an effective means of making a product affordable and available.

The Market Has Been Transformed by Competition Since McCarran-Ferguson

The McCarran-Ferguson Act had the effect on the insurance market that Congress intended. By providing that the antitrust laws would be preempted should the states occupy the field with rate regulation, Congress incentivized the states to enable and regulate collusive practices.

In the years following McCarran-Ferguson, competition was stifled. States uniformly passed the All-Industry laws, under which state insurance departments reviewed prices in advance to ensure that rates were not inadequate, excessive, or unfairly discriminatory. Rating bureaus ruled. Prices were made in concert by cartels in every state.

The market, however, began to transform in the 1960s. Independent carriers, which developed their rates outside of the bureau system, appeared -- and thrived. In the following decades, personal auto and homeowners have become intensively competitive markets. This is evident to the most casual observer today.

For instance, as I watched my Illinois Fighting Illini wear their orange uniforms all the way to the national title game on their "Road to the Final Four" this spring, I was inundated with commercials from at least four of the major national carriers, each claiming to offer a better price than the rest, several of them naming the others by name and giving specific examples of price savings by consumers.

This is interstate commerce. It is the very embodiment of a competitive marketplace. But it is still regulated state by state with a heavy dose of price controls. I believe that this dynamic should be regarded as highly irregular.

Mismatch: Price Controls Are Not an Affordability/Accessibility Tool

The marketplace has matured, but the regulatory system has not with respect to oversight of price. Rate regulation, which was an appropriate tool for solvency regulation at the time of McCarran-Ferguson, has morphed into a means of attempting to ensure availability and affordability of insurance.

Today, states frequently view rate regulation as a necessary tool in keeping insurance affordable for consumers. This represents a total mismatch of ends and means. The end goal of insurance

rate regulation, as conceived by policymakers through the passage of the McCarran-Ferguson Act, was not to keep prices from being excessive, it was to keep them being inadequate.

The notion that price controls should not be used to promote affordability and availability in a competitive marketplace is completely uncontroversial. I doubt you could find a credentialed economist to disagree with that generic statement. Yet that is precisely what states routinely attempt today in the insurance marketplace, with disastrous results.

This committee over the years has well documented the problems that price controls have created in the insurance market. Predictably, states which have relied heavily on this tactic have badly choked the supply of insurance. The usual result is that prices are no lower than they would be otherwise, and availability is severely restricted.

Policymakers in New Jersey now acknowledge that years of rate rollbacks and prior approval regulation did not keep rates down. They further bemoaned the affects of these punitive regulatory policies on availability: It became common for well-qualified risks to have to wait weeks and go begging to be taken on by carriers who wanted to reduce rather than grow market share.

In pressing for competition-based reforms, former Governor McGreevey noted that "it's no longer possible to walk into an agency and walk out with a policy." He criticized "the insanity of a system that forces good drivers to wait for weeks, even months, to obtain coverage ... when carrier after carrier gives up on New Jersey." Thus, he concluded that "[f]or too long, the auto insurance crisis has been viewed as an affordability issue. Every day we see new evidence that it is no longer just about affordability, it is very much about availability."

New Jersey's experience validates the simple economic truism that government price controls undermine competition by causing supply to wither. Sellers will not fully participate in a market when they fear government capture of their capital. Inadequate capital and supply of a product causes severe availability problems and great consumer harm.

Even California, which has had relatively low rate increases compared to the national average since instituting aggressive price controls under Proposition 103 in 1988, is a poor advertisement for rate regulation. Statistics clearly demonstrate that moderate rates have been caused by an extraordinarily favorable loss climate in California since 1988. The substantial decline in payouts has been fueled by several developments, including a landmark court decision which limited jury awards; strong drunk driving and seatbelt laws; and progressive road construction standards.

In fact, rates in California have not been as low as they should have been given the extraordinary relative decline in loss payments since 1988. Instead, carriers, afraid of government capture of their capital, appear not to have sought rate decreases commensurate with losses and expenses. Instead, they likely hedged against the risk of politically-driven rejections of necessary and justified rate increases in the future. As a result, consumers may not have enjoyed the full reduction in rates that was likely justified by actual and expected losses, and which should have been available to them in a normal, responsive, and well-functioning market.

Price controls are designed to address and mitigate a market defect: monopolistic conditions. As discussed above, when a market is not ruled by, using the Supreme Court's description, "what

Adam Smith calls the higgling of the market," but is rather "of monopolistic character," government has a proper role regulating in the stead of market forces.

The insurance market, however, has since been transformed by competition, and in competitive markets, price controls create market defects. The results in New Jersey and California -- an availability crisis spurred by diminished supply, and the failure of the market to fully internalize favorable conditions, respectively -- are the unfortunate, but highly predictable, results of what happens when government tries to micro-manage the supply and demand curves which, left to do their work unabated, are so helpful to consumers in free markets.

Thorough Regulation: In Illinois, Government Regulates Only What Competition Cannot

Illinois has achieved great success by regulating rates through competition. I was privileged to serve as the Illinois Director of Insurance for four years, from 1999 to 2003, and I found that the so-called Illinois system works for the benefit of consumers.

The Illinois insurance code does not have the "magic words," dating back to the post-McCarran-Ferguson All-Industry Bills, which empower the insurance commissioner to review rates to ensure that they are not "inadequate, excessive, or unfairly discriminatory." The Director's authority to regulate rate levels disappeared thirty years ago; prohibitions against unfairly discriminatory and/or unfair or deceptive acts or practices remain on the books.

Even though the Director has no authority to review rate levels, rates are surely regulated in Illinois: Instead of government passing on the proper price a seller can pay in a competitive market, personal lines auto and homeowners rates are regulated by the most ruthless force in a capitalist economy, the pressures of supply and demand.

The results are impressive. Illinois has consistently had the most or nearly the most carriers writing auto and home insurance of any state in the country. And prices have been stable and moderate, ranking either in the middle of the state rankings or below average: 27th highest in auto and 39th highest in homeowners in studies conducted during the last decade.

Coverage in Illinois is not just affordable, it is widely available. The assigned risk plans for auto and homeowners insurance in Illinois have traditionally been negligible, far less than 1% of the market. The inability of qualified risks to gain coverage (such as the residual markets approaching or exceeding one-third of all drivers in the heavy rate regulatory environments seen in recent years in states like Massachusetts, New Jersey, and South Carolina) is unheard of in Illinois.

Illinois regulates the insurance marketplace in areas where consumers are in need of government intervention. The average policyholder is not an accountant or an actuary and cannot be expected to understand her carrier's balance sheet, so the state must regulate carrier solvency affirmatively and aggressively. Likewise, most consumers are not contract lawyers and do not understand the ins and outs of their policies, so the states should review and approve forms. And consumers are at an information disadvantage vis a vis carriers regarding claims handling and related behavior, so the states need to regulate market conduct and consumer complaints. Illinois does all this proactively.

But consumers do know how to comparison shop based on price. They do it every day, and every other product they buy that is competitively sold is not subject to price controls. This applies to pleasure goods and necessities alike.

The homes and automobiles that people need insurance for are perhaps the most expensive purchases they make, far more costly and difficult to execute than insurance, and are sold in relatively byzantine markets. The prices of cars and houses, however, are not regulated while the rates of the insurance products which cover those purchases are.

Have the people in the committee room here today found valuing real estate -- which involves, among other things, understanding the value of land, understanding home inspection reports, comparing the benefits and drawbacks of neighborhoods, and trying to gauge the rate of appreciation in the housing market -- easier than pricing an insurance policy? Are consumers more at risk buying auto insurance than they are walking into the car showroom and trying to figure out whether the list price is reasonable and the back and forth between the manager and the sales agent is fair to them? I think the answers to these questions are "no," but the prices of homes and automobiles (and all other non-monopolistic products) are not regulated by government. Why?

These prices are not regulated by government because it is well understood that the best and most efficient regulator of prices for the benefit of consumers is competition. Supply and demand forces sellers to offer goods and services at the proper price -- what consumers are willing to pay with an appropriate profit built in for the seller. Competition keep prices reasonable; it reacts to the marketplace in much more nimble fashion than government can ever hope to; and it ensures that capital, without fear of irrational government capture, flows to markets, producing adequate supply.

It is somewhat misleading to label Illinois with the shorthand moniker of a "deregulated" market. Everything is regulated in Illinois. In areas where consumers cannot fully protect themselves, like solvency regulation and market conduct, government takes proactive steps. But when it comes to prices, where consumers know how to, and can and will, empower themselves, government lets the law of supply and demand regulate the market. By leaving price regulation to the experts -- market forces -- state regulatory agencies can focus their scarce resources on areas where government intervention is necessary to protect consumers.

In Illinois, government's role in overseeing rates is limited to monitoring the market to ensure that the strongest regulator of prices -- competition -- is in place. Illinois law, which does not empower the Director to regulate price levels, does instruct him to prepare an annual report to the legislature analyzing the property-casualty markets and determining whether competition is present. This statute, known as the Cost Containment Act, ensures that consumers are in fact receiving the regulatory benefits of competition, as it will alert policymakers if monopolistic conditions emerge.

The Director's cost containment reports annually demonstrate that there is full and strong competition between sellers of personal auto and homeowners insurance in Illinois. The Herfindahl/Hirschman index calculations used in the Division of Insurance's statistical analysis demonstrate that these markets are not concentrated but rather are highly competitive.

I also note that the Division's calculations demonstrate that the professional liability markets are highly non-competitive, which is why the insurance code has always given the Director authority to regulate these rates for excessiveness and inadequacy.

Illinois presents a solid and well-developed example. The so-called "open competition" system has been in place for over three decades and has during that time enjoyed broad bipartisan support in the General Assembly. The reason for this is simple: it works. In fact, it would be shocking if the system did not work, since it is merely the implementation of time-tested and bedrock ideas about how markets work for the benefit of consumers.

I sometimes find myself cringing, however, when the "Illinois system" is discussed. It is often cited or described, sometimes even by proponents, as a strange, dark, and mysterious being. The implication is that this is some kind of remarkable experiment that somehow, unexplainably, has managed to be successful. Even though it is a bizarre outlier, the argument seems to go, it is worth considering because it has produced good results.

I submit that this is the wrong way to approach the issue. Illinois should not be considered an "experiment" nor should it be regarded as radical. The way Illinois regulates could not be more mainstream. Instead, any system of overseeing commerce which empowers government to regulate price levels in a competitive market is strange. The default rule should be competition, not price controls.

It is not miraculous -- or even notable -- that Illinois has achieved good results by letting competition regulate auto and homeowners insurance rates. Illinois' healthy market is precisely what one would expect, and it is perfectly consistent with prevailing American public policy.

Using price controls as an affordability and availability mechanism, by contrast, is not what one would expect. It only happens in insurance because of this industry's unique history. Price controls were appropriately used as a solvency tool in a system sanctioned and driven by Congress. But price controls have morphed into something for which they were never intended -- much to the detriment of consumers.

Congress's Role Regarding State Price Controls Over Insurance Rates

This is very much Congress's business. The issues I am discussing profoundly impact interstate commerce. One need look no further than New Jersey to understand the national commercial implications of this issue.

As New Jersey passed more and more punitive laws in the late twentieth century, carriers began to bleed more and more red ink from their New Jersey books of business. This diminished the common fund and threatened the well-being of consumers in other states, so companies, who had a responsibility for the well-being of all their policyholders, chose to quarantine the risk from New Jersey by establishing single state companies with separate, New Jersey-only capital. The supply of insurance in New Jersey then dwindled to the point of a crisis as more and more carriers began to limit how much they would write and/or took action to withdraw from the market altogether.

Since New Jersey has begun moving toward a more competitive marketplace, however, the trend has reversed. Carriers which were leaving have tabled those plans, and carriers which had previously refused to do business in New Jersey have decided to enter.

A prominent success story for New Jersey's market-based reforms is GEICO, a leading national writer which had before chosen not to seek business in this very populous state. GEICO has now entered the market, and has done so "whole hog": It has not formed a single state company but rather is doing business through the parent corporation. This decision would never even have been contemplated under New Jersey's old, aggressive rate regulation regime.

New Jersey is an extreme example, but there is significant reason to be broadly concerned that price controls and government capture of capital in some states can affect consumers in other states.

Testimony in prior Subcommittee hearings has also suggested that the property-casualty market on the whole is likely undercapitalized. Fear of government capture of carrier capital prevents investment from fully flowing to the market. Investors react negatively to concerns that rate regulation will prevent sellers from reacting to changes in the market and adjusting their prices -- either up or down -- as appropriate. Supply is therefore not as ample as it should be in a market-based system, resulting in prices no lower than they would be under competition -- and diminished availability of product.

Thus, state rate regulation is certainly a fair topic for Congressional debate and possible action. Not only do state price controls fall squarely within Congress's oversight of interstate commerce, they are very much a result of prior Congressional action. The appearance of state laws which authorize government to regulate price levels for inadequacy and excessiveness did not appear in every state out of the blue; they have largely resulted from a policy choice made by Congress in the McCarran-Ferguson Act.

This committee has received ample testimony in recent years that the market has changed dramatically since 1945. The need to effectively shut down competition receded long ago. But the regulatory tools which were designed to disable competition are still here today, only they are being used to an end for which they were not created.

Nothing could be more appropriate than for the Congressional committee tasked with regulating a particular kind of interstate commerce to examine that market; create a full record which demonstrates that the conditions which spurred a previous and unique Congressional policy choice are no longer present; and to adapt policies which are consistent with the marketplace which exists today, thus bringing an outlier industry into line with prevailing American public policy favoring regulation of competitive markets by supply and demand.

This is proper and necessary oversight. The presumption in favor of competition throughout the economy has been turned on its head in insurance regulation. That was appropriate in the market of 1945. It is not justified today.

<u>I therefore urge the committee to consider the following two steps.</u> First, not only should Congressional action pertaining to rate regulation be on the list of subjects for consideration in the SMART Act, it should be at the top of the list, bar none, since previous Congressional legislation helped to facilitate the current system, and since price controls substantially impact

interstate commerce. Second, Congress should consider modernizing its oversight of insurance by establishing a national policy which effectively preempts the inappropriate and ineffective practice whereby states attempt to provide availability and affordability of auto and home insurance through price controls.

Congress's regulatory power over interstate commerce exists because in some situations the states cannot be expected to overcome political obstacles and collective action problems. This is a classic case. Price controls made sense at some point long ago, but they gained a political backing in the states which has far outlasted the policy rationale for the practice.

Many regulators from other states have told me over the years that they believe that price controls are ineffective and a poor use of government resources. But they must apply the laws on their books, and in many states price controls are a favorite political issue for state legislators. So regulators, some of whom would rather use their scarce budgets to regulate areas of insurance where consumers cannot help themselves, must bite their tongues and enforce government's judgment about proper prices for that of the free market.

Because of political considerations, the states are unlikely to address this issue through the NAIC. Even if the NAIC were inclined to support competitive regulation of personal auto and homeowners insurance, it is doubtful that this would have significant effect. State legislators, not regulators, pass the laws which require insurance departments to scrutinize and sign off on rate levels.

As a result, the prevailing national policy in favor of competition is turned on its head in a large and essential industry, for the wrong reasons, and with bad results. This situation directly implicates the Constitutional rationale for the Commerce Clause: Congress is the only body which is institutionally designed and empowered to step in and solve thorny collective action problems which threaten the smooth functioning of interstate commerce.

Conclusion

Insurance is a product crucial to the well-being of our society. Individuals and families stricken by a loss rely on the protection provided by insurance to keep them off welfare, and the economy as a whole relies on the presence of insurance coverage to support risk-taking and spur growth. The product is so infused with the public good that it should be, and is, a heavily regulated enterprise. State regulation has provided essential oversight of the industry, and thus great service to the common good, for many decades.

I have not been an advocate of federal chartering of insurers. My strong preference has always been for retaining the primacy of state regulation if feasible. I believe, however, that the presence of price controls in the personal auto and homeowners marketplace badly undermines this goal. As I will briefly discuss below, that is why I feel so strongly and have spoken so bluntly about price controls today.

I believe that state rate regulation is presumptively unnecessary. It does not produce the results for which it is used today -- affordability and availability of product. Instead, it restricts supply, distorts the market, and harms consumers.

Furthermore, rate regulation has at least two more extremely harmful, and very practical, results. First, as discussed above, it diverts resources from the necessary solvency, market conduct, forms, and consumer complaints work that free market forces cannot regulate, and that the states must perform for the protection of consumers.

And secondly, price controls needlessly antagonize property-casualty carriers, who are forced to live under a punitive regulatory regime that no other competitive industry faces. Property-casualty carriers are natural allies of state regulation in the political arena: Their products are attuned to local markets since they must react to the different loss climates driven by factors particular to individual states, like weather and tort law. But more and more property-casualty insurers, including many previous staunch supporters of state regulation, are openly supporting a federal charter in Congress. This is a shame for supporters of state regulation.

I would like to conclude by expressing my gratitude to Chairman Baker for his outspoken support of competitive markets in property and casualty insurance, particularly in the personal automobile and homeowners lines. The issue of Congressional action with respect to state price controls is often described as the most politically difficult of all the titles under consideration in the SMART Act. But Chairman Baker has steadfastly maintained that, despite the political obstacles, addressing the anti-competitive practice of price controls must remain prominently on the subcommittee's agenda. Both he and Chairman Oxley should be commended for their clear thinking and political courage on this subject.

Thank you for your consideration and the privilege and honor of testifying before you today. I will of course be pleased to answer any questions from the committee.

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